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MICHAEL RODAK,

In the Supreme Court of the United States

October Term, 1972

No. 73-32

FINANCIAL INDUSTRIAL FUND, INC.,
Petitioner,

v.

McDONNELL DOUGLAS CORPORATION,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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No.

FINANCIAL INDUSTRIAL FUND, INC.,
Petitioner,

v.

McDONNELL DOUGLAS CORPORATION,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment herein of the United States Court of Appeals for the Tenth Circuit entered in the above-entitled case on February 20, 1973, petition for rehearing denied on April 5, 1973.

OPINIONS BELOW

The opinion of the United States District Court for the District of Colorado denying respondent's motion for summary judgment is set out in Appendix A and is reported at 315 F. Supp. 42.

The judgment and order of the District Court on the jury verdict, set out in Appendix C, has not yet been reported in the official reports but has been reported in CCH Federal Securities Law Reports, ¶92,811.

The opinion of the District Court denying motions for judgment notwithstanding the verdict and for new trial, set out in Appendix D, has not yet been reported in the official reports but has been reported in CCH Federal Securities Law Reports, ¶93,004.

The opinion of the Court of Appeals reversing the judgment of the District Court, set out in Appendix E, has not yet been reported in the official reports but has been reported in CCH Federal Securities Law Reports, ¶93,773. The order of the Court of Appeals denying petitioner's application for rehearing is set out in Appendix F.

JURISDICTION

The judgment of the Court of Appeals (App. E, p. 39a) was entered on February 20, 1973, and a petition for rehearing was denied on April 5, 1973 (App. F, p. 55a). Jurisdiction of this Court is invoked under 28 U.S.C. §1254 (1).

QUESTIONS PRESENTED

In a civil action for damages based upon Rule 10b-5 under the Securities Exchange Act of 1934 (citations infra pp. 3-4), the United States District Court entered judgment on a jury verdict in favor of petitioner and denied respondent's motion for judgment notwithstanding the verdict. The Court of Appeals reversed, holding that the District Court should have granted respondent's motion for judgment notwithstanding the verdict.

1. Did Court of Appeals err in holding, contrary to standards enunciated by this Court and applied by the

District Court, that the issuer of securities traded on national securities exchanges has no duty to disclose to public investors material adverse information until the issuer, in the exercise of its business judgment, has developed verified figures which are "ripe for publication"?

2. In a case against the issuer of securities traded on a national securities exchange alleging a fraudulent and deceptive course of conduct in connection with plaintiff's purchases, did the Court of Appeals err in holding, contrary to the standards enunciated by this Court and applied by the District Court, that the sole justiciable question is the silence of the issuer at the time of plaintiff's purchases?

3. Where the jury was instructed in accordance with legal standards enunciated by this Court, did the Court of Appeals, in overturning the jury verdict, deprive petitioner of a right guaranteed by the Seventh Amendment to the United States Constitution and the decisions of this Court?

CONSTITUTIONAL PROVISIONS, STATUTES, AND RULES INVOLVED

1. The constitutional provision involved is the Seventh Amendment to the United States Constitution.

> "In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved; and no fact tried by a jury shall be otherwise reexamined in any court of the United States than according to the rules of the common law."

2. The statutory provision involved is 15 USC §78j(b).

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange—

* * *

(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

3. The federal regulation involved is 17 CFR § 240.10b-5, which provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

STATEMENT OF THE CASE

Petitioner is, and at the pertinent time was, a mutual fund with principal offices at Denver, Colorado. At the pertinent time, respondent was engaged in the manufacture of aircraft and of various vehicles and systems for the space program; it is presently so engaged, although its corporate structure was changed subsequent to the events here involved.

I. THE CIRCUMSTANCES PRECEDING PETITIONER'S PURCHASE

A. Respondent's Refinancing Program

This case had its genesis early in 1966 when respondent, assisted by Merrill Lynch, Pierce, Fenner & Smith, Inc., undertook a major refinancing program designed to alleviate a serious shortage of cash working capital. The first step in the program was to call for redemption some $28 million of outstanding convertible debentures. The second step was to sell to the public a larger issue of new convertible debentures. Merrill Lynch, which was a party to the trial in the District Court, was engaged as consultant and standby purchaser in connection with the call of the outstanding debentures and as underwriter for the new debenture issue. On or before May 3, 1966, the date upon which conversion rights expired, virtually all of the outstanding debentures had been converted into common stock.

B. The Public Information

During the four months prior to the call date of the outstanding debentures, the respondent took actions and made public announcements which were intended to and did in fact maintain the market price of the common stock above the conversion price of the debentures. On

January 19, 1966, respondent declared a 3% stock dividend and an increase in the quarterly cash dividend from 15¢ to 25¢ per share, accompanied by an announcement that earnings for the fiscal year ended November 30, 1965 were $3.15 per share, up from $2.96 per share in fiscal 1964 (R. 130, 851, Ex. AM-4). On March 25, respondent announced that its earnings in the first quarter ended February 28 rose to 87¢ per share, up from 71¢ per share a year earlier, and that the company's higher level of activity "will be reflected increasingly in earnings later this year, and, of course, in 1967." (R. 130, 871, Ex. AM-24.) At respondent's annual meeting on April 20, management gave a glowing report on the rising trend of sales and backlog figures and stated that despite start-up costs associated with the introduction of new models of both the DC8 and DC9, earnings for 1966 should show improvement, although the full impact of its growing business would not be felt until 1967 (R. 73, 983, Ex. L; R. 130, 877, Ex. AM-30). There were numerous announcements in the financial press regarding orders received by the respondent from the government and commercial airlines (R. 130, 850, et seq.)

Until the first week in June, security analysts were estimating respondent's 1966 earnings in the $4.00 to $4.25 range, despite the then known delays in procuring jet engines and landing gears from suppliers (R. 73, 981, 988, Exs. K and O), and there was no public statement by respondent detracting from this constant stream of favorable earnings reports and optimistic forecasts.

On June 2, respondent issued a press release stating that it expected a delay of a few weeks in making deliveries during the fiscal year on three DC8 and fifteen DC9 commercial jetliners and that the delays would adversely affect respondent's earnings in the current fiscal year by pushing some deliveries scheduled for the current year into fiscal 1967 instead (R. 130, 884, Ex.

AM-37). On June 7, respondent filed with the Securities and Exchange Commission a registration statement for its proposed new issue of $75 million of convertible debentures in which its earnings for the five months ended April 30 were stated to be 85¢ per share (R. 73, 997, Ex. R; R. 130, 892, Ex. AM-46). Concurrently, the information disclosed in the registration statement was reflected in a research report published by a Wall Street brokerage firm which lowered its estimates for fiscal 1966 earnings to the $3.25 to $3.50 per share range (R.73, 993, Ex. Q).

C. Information Not Disclosed to the Public

The evidence in the case includes many material facts regarding respondent's financial problems known internally by respondent and Merrill Lynch which were not disclosed to the public. Only a few need be mentioned here. Respondent's management was well aware in April 1966 that there was an undercosting problem with the DC9 (R. 470, Ex. AJ-14). Respondent's president ordered a special task force over the Memorial Day weekend of May 1966 because of cost and inventory problems in the aircraft division, and advised Merrill Lynch, on or about May 31, that the earnings estimate for the 1966 fiscal year had dropped to about $2.00 per share (R. 273). Respondent's assistant comptroller knew by June 14 of the probable necessity of a $3.7 million inventory write-down (R. 505). On June 20, the respondent's president advised Merrill Lynch that the earnings situation was much worse than had been previously indicated, and that Merrill Lynch was free to withdraw from the underwriting of the new debenture issue (R. 279).

II. THE TRANSACTIONS HERE INVOLVED

On June 22 and 23, petitioner, with knowledge of the public information referred to in Paragraph B above and

without knowledge of the internal information referred to in Paragraph C above, purchased 80,000 shares of respondent's stock at an average price of approximately $88.00 per share (R. 100). The purchases were effected on national securities exchanges, and there was no direct dealing or contact between petitioner and respondent. On Friday, June 24, respondent issued a wire release announcing a net loss of $3,463,000 or 66 cents per share for the second quarter of the 1966 fiscal year ended May 31, a net profit of 12 cents per share for the six months ended May 31, and its belief that for the full fiscal year 1966 earnings, if any, would be nominal (R. 108, 291, and 942; Ex. D-3).

Trading volume and price fluctuations on the New York Stock Exchange were greater on the day preceding respondent's release than on the day of the release, as shown in the following summary of NYSE transactions in respondent's stock during the week ending Friday, June 24 (R. 374, Ex. AM 73-A):

Date	No. of Shares Traded	Prices		
		High	Low	Close
Monday, June 20	24,500	85	81 7/8	85
Tuesday, June 21	66,200	90	86	86 1/4
Wednesday, June 22	66,500	90 1/2	87 1/2	87 1/2
Thursday, June 23	261,500	88 3/4	77 5/8	78 3/4
Friday, June 24	211,100	77	74 1/2	76

The stock continued to decline, and between July 1 and July 8, petitioner sold at an average price of approximately $64.00 per share the entire 80,000 shares purchased by it on June 22 and June 23. (R. 114).

III. PROCEEDINGS IN DISTRICT COURT

The District Court denied motions for summary judgment made by respondent and Merrill Lynch. The District Court's memorandum opinion and order (App. A, p. 1a) dealt with the elements of proximate cause, scienter, and reliance, pointing out the controverted issues of fact with respect to each.

The case was tried to a jury of twelve, which heard the testimony of nine witnesses and examined more than 150 exhibits. Judge Doyle's charge to the jury is set forth in Appendix B, p. 7a. Certain portions of the charge are particularly apposite. He noted that petitioner invoked all three subdivisions of Rule 10b-5 and stated his belief that only subdivisions (2) and (3) were applicable.

> "Now, in my judgment, ladies and gentlemen, the only provisions of this 10(b) (5) which come into play here are Parts 2 and 3; namely, the making of an untrue statement of a material fact or the omission to state a material fact, the giving of a half-truth; failure to state all the facts. I think this is what their theory is. Or the engaging in an act or practice or course of business — and this is virtually saying the same thing in a different way — namely, that there was a course of business carried out over a period of time which they — which had the purpose and the effect of making — giving out false information, positive facts, or withholding information whereby an untrue picture was the result.***" (App. B, p. 14a)

He pointed out that the acts and practices complained of must be knowingly and willfully carried out and that negligence was not enough (App. B, pp. 14a-15a).

At the conclusion of the trial, the jury rendered a verdict for petitioner in the sum of $712,500.

The respondent and Merrill Lynch filed motions for judgment notwithstanding the verdict and for a new trial. The District Court's opinion denying these motions appears in Appendix D hereof. The summary of the evidence therein contained warrants emphasis.

"In summary then it was open to the jury to conclude from the evidence:

1. That there was an underlying motive for both defendants to withhold the facts and postpone the inevitable so as to first redeem the old debentures and, secondly, to market the new issue. They were also motivated no doubt by the hope that some miracle would save Douglas.

2. Both Douglas and Merrill Lynch were aware from the evidence which was presented that the problems of Douglas were severe and that the earnings picture was fast deteriorating and that when this became public, the Douglas shares would decline substantially. The knowledge of Merrill Lynch was evident from the circumstances and also from its leaking and tipping.

3. The initial optimistic reports and the withholding of the bad news violated the duty owed by both defendants.

4. Plaintiff would not have purchased if the facts had been announced. Thus, defendants' conduct was the cause of plaintiff's loss.

"The duty of Merrill Lynch to disclose to the public in these circumstances is less clear than that of Douglas. This is not to say though that no duty existed for Merrill Lynch. In view of the demonstrated complicity between the two, and considering

the fact that Douglas was a large corporation living in close proximity to the public and Merrill Lynch occupies a similar position and is or should be acutely aware of consequences of nondisclosure, it cannot say that it owed no duty to reveal the facts — that this was up to Douglas as principal. Merrill Lynch did, after all, communicate the facts internally and privately.[4] If its first duty was to Douglas, and we doubt this, it would and should have terminated the relationship." (App. D, pp. 32a-33a.)

IV. PROCEEDINGS IN COURT OF APPEALS

An appeal was taken initially by both respondent and Merrill Lynch, but was perfected only by the respondent. The respondent contended that the elements of an action under Rule 10b-5 were not established and, more specifically, that petitioner failed to show facts to meet the scienter standards which were applicable to a complaint alleging a failure to issue the special earnings statement at an earlier time, and that under the evidence the District Court did not apply the correct standard in ruling on its motion for a directed verdict and judgment n.o.v. Respondent further argued that incorrect instructions were given by the District Court on these matters and contended further that the proper statute of limitations had not been applied. Petitioner filed a cross-appeal challenging the jury's calculation of damages under the federal out-of-pocket loss rule, and the District Court's denial of compensatory pre-judgment interest.

The case was originally heard by a panel of the Court of Appeals, but it was thereafter heard en banc at which the parties were instructed to give particular attention to the issue of scienter and the issue of the proper statute of limitations.

The Court of Appeals reversed the judgment entered on the jury verdict (App. E, p. 39a). The Court stated that the only issue with which it was concerned was whether the silence of respondent at the date or dates of the stock purchases by petitioner gives rise to a cause of action under Rule 10b-5. As to this issue of "silence,"the Court stated that the decision to issue a special earnings report and the timing thereof are fundamentally and almost exclusively matters within the discretion and business judgment of management and that the corporation may not be held liable where management's discretion and judgment is exercised in good faith and with due diligence. The Court held, "as a matter of law," that respondent "exercised good faith and due diligence in the ascertainment, the verification, and the publication of the serious reversal of earnings in May." Further, the Court held that there was "no showing" by petitioner "of the reliance required nor facts to meet the standard of due diligence on its part." (App. E, p. 52a). No decision was made as to the applicable statute of limitations.

Petition for rehearing was denied on April 5, 1973 (App. F, p. 55a).

REASONS FOR GRANTING THE WRIT

THE COURT OF APPEALS HAS DECIDED FEDERAL QUESTIONS IN A WAY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

A. The Decision of the Court of Appeals Contravenes the Congressional Purpose to Protect the Investing Public.

The petition raises substantial questions of grave importance and concern to public investors engaged in impersonal securities transactions on national securities

exchanges and over-the-counter markets. The Court of Appeals' holding under a business judgment standard that an issuer of securities traded on national markets has no duty to disclose to these public investors material adverse information until verified figures or other data are "ripe for publication" undermines one of the stated purposes of the statute — "to insure the maintenance of fair and honest markets in such transactions," and is clearly in conflict with the decisions of this Court. This Court has repeatedly enunciated the congressional purpose of the 1934 Act and its companion legislative enactments "to substitute a philosophy of full disclosure for a philosophy of caveat emptor and thus to achieve high standards of business ethics in the securities industry," and that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Securities and Exchange Commission v. Capital Gains Research Bureau,* 375 U.S. 180, 186 (1963); *Superintendent of Insurance v. Bankers Life & Casualty Company,* 404 U.S. 6, 12 (1971); *Affiliated Ute Citizens v. U.S.,* 406 U.S. 128, 151 (1972).

Manifestly, fair and honest markets cannot be maintained and the remedial purposes of the statute are thwarted where issuers of securities traded in those markets have no duty to public investors to disclose materially adverse developments or to correct false and misleading information on the basis of which the public is trading, until the issuer in its own best judgment determines that verified figures or other data are available and ripe for publication. To so delimit the issuer's duty is to undermine the integrity of national securities markets and establish a double standard under Rule 10b-5 — one for face-to-face transactions and another, greatly emasculated, for impersonal market transactions.

Surely the Court of Appeals could not have meant that a prospective buyer negotiating directly with respondent on June 20th would not be protected by Rule 10b-5 because the company had not verified, to its satisfaction, the earnings figures for six months through May. In such a face-to-face situation, the company could have disclosed the materially adverse developments subsequent to April 30th or adjourn negotiations; but it could not with impunity remain "silent" and close the sale. Indeed, the evidence shows, that respondent so appraised the situation. Respondent did not wait for verified figures when it informed Merrill Lynch on June 20 that the situation was so serious that Merrill Lynch was free to withdraw from the underwriting of the new debenture issue (R. 279). Respondent's president testified that he had a "duty" to so advise Merrill Lynch (R. 284). To hold that respondent did not have a duty to so inform investors trading on national securities exchanges, or in the alternative to suspend trading of its stock, violates the statutory purpose and the holding of this Court in *Superintendent of Insurance:*

> "... (W)e read §10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face-to-face.***" (404 U.S. at 12).

In conformity with this Court's decisions, the lower courts have articulated the purpose of the 1934 Act and Rule 10b-5 in terms of protecting the "investing public" without discriminating between market transactions and personal dealings. As stated in *Kahan v. Rosenstiel,* 424 F.2d 161 (3d Cir. 1970):

> "The Act was designed to eliminate deceptive and unfair practices in security trading and to protect the public from inaccurate, incomplete, and

misleading information. The thrust of the Act and the decisions interpreting it is to give the investing public the opportunity to make knowing and intelligent decisions regarding the purchase or sale of securities." (424 F.2d at 173.)[1]

B. Failure To Disclose Not The Sole Issue

In holding this to be solely a non-disclosure or "silence" case, the Court of Appeals erroneously disregarded the other correlative and mutually supporting provisions of Rule 10b-5 and the evidence of violations thereof. This Court has rejected such a literal and formalistic construction of Rule 10b-5. In *Superintendent of Insurance*, the corporate seller of government securities was duped into believing that it would receive the proceeds. The scheme involved material misrepresentations and material non-disclosures which together constituted a deceptive act or practice within the meaning of Rule 10b-5. This Court did not belabor technicalities as to the applicable subdivision or part thereof, but stated clearly and concisely:

> "Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under §10 (b), ***." (404 U.S. at 12)

The correlation of the non-disclosure of a material fact and "a course of business" or a "device, scheme or artifice" that operates as a fraud was again recognized by this Court in *Affiliated Ute Citizens*, even though that case involved primarily the failure to disclose material facts.

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[1]See also *Intercontinental Industries, Inc. v. American Stock Exchange*, 452 F.2d 935 (5th Cir. 1971) and *Freed v. Szabo Food Service, Inc.* (ND Ill. 1964), CCH Fed. Sec. L. Decns. ¶91,317.

To single out respondent's "silence" as the only issue in the instant case is to ignore reality. Respondent's shocking earnings report of June 24 did not occur in a vacuum. During the entire five months prior to that release, the respondent had been anything but silent. It had been most effusive in its public announcements. As the District Court noted, it was the combination of the inaccurate, incomplete, and misleading information publicly extant at the time of petitioner's purchase and the respondent's failure to take appropriate action, under such circumstances, to protect the investing public, which together constituted a fraudulent practice and course of conduct within the purview of Rule 10b-5. In holding that respondent had no duty to disclose its drastically deteriorating earnings until it developed verified figures, the Court of Appeals disregarded the fact that petitioner and other investors were buying respondent's stock in reliance upon information which respondent knew to be inaccurate, incomplete, and misleading. As above mentioned, respondent did not hesitate to inform Merrill Lynch of the drastic change from earlier representations.

C. Petitioner's Reliance And Due Diligence Were Established In Accordance With Standards Enunciated By This Court

Even if this were strictly a non-disclosure or silence case, the holding of the Court of Appeals that there was "no showing" by petitioner of the reliance required is in conflict with the criterion applied by this Court in *Affiliated Ute Citizens.* In that case, which involved primarily a failure to disclose material facts, this Court noted that positive proof of reliance is not a prerequisite of recovery and stated: "All that is necessary is that the facts withheld be material in the sense that a *reasonable investor* might have considered them important in the making of this decision." (406 U.S. at 153-4; emphasis

supplied.) Reliance, in accordance with this standard, is demonstrated by the sharp decline in the price of Douglas stock following the June 24 release.[2] Moreover, in addition to petitioner's testimony that it would not have purchased the stock had it known of the drastically deteriorating earnings as disclosed in that release, there is the hard fact that petitioner commenced disposition of the stock seven days thereafter.

In its finding that there was "no showing" by petitioner of "facts to meet the standard of due diligence on its part," the Court of Appeals implies that the petitioner, because of its presumed sophistication in investment matters, should have had access to information known only to company officials and their confidants. The decisions of this Court plainly reject such a discriminatory construction. In *Superintendent of Insurance,* where the fraud was perpetrated by an officer of the defrauded corporation, this Court stated: "The Act protects corporations as well as individuals ***." (404 U.S. at 10.) Also, in *Affiliated Ute Citizens,* this Court adopted the non-discriminatory standard of a "reasonable investor."[3] In the instant case, the District Court's charge to the jury dealt with the "sophistication" factor in a manner consistent with the pronouncements of this Court. The jury was instructed:

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[2]A. Bromberg, Securities Law: Fraud, SEC Rule 10b-5, Sec. 7.4(3) (d), p. 168.5: "In the last analysis, it is the market which determines the value of information and which should, therefore, be the model for determining materiality." See also Sec. 7.4 (3) (d) p. 168.6, footnote 115.2: "The very fact that an insider worries whether he has material information is some evidence that an investor's judgment is being affected."

[3]In *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied, sub nom., Coates v. SEC*, 394 U.S. 976 (1969), Judge Waterman, writing for the majority, discussed materiality in terms of what would influence a "reasonable investor" and, in this connection, stated: "The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders." (401 F.2d at 850.)

"Now, in determining this element of reliance, you are free to consider the level of knowledge of FIF, the plaintiff, and the amount of information they had; their ability to form a judgment. But this doesn't mean that because it can be said that they do have a research department and they are sophisticated that they are not to be protected by these laws the same as anybody else. As I say, you can just weigh this factor. But it's not conclusive. And if they were indeed misled, why, they have just as much right to complain about it as anybody else. As I say, I want to put that in place. That's all. And I think I'm obligated to do so because I think there has been a lot of emphasis as to their level of sophistication. And indeed you may consider it. But it's not the controlling factor. If you are convinced that they were deceived and acted in response to deception, in that event, why, they could of course recover." (App. B, p. 17a.)

D. The Jury's Determination Of Factual Issues In Accordance With Legal Standards Enunciated By This Court May Not Be Set Aside On Appeal.

The jury's prerogative to determine factual issues is guaranteed by the Seventh Amendment to the United States Consitution and by the decisions of this Court. In *Lavender v. Kurn,* 327 U.S. 645, 653 (1946), this Court stated:

"It is no answer to say that the jury's verdict involved speculation and conjecture. Whenever facts are in dispute or the evidence is such that fairminded men may draw different inferences, a measure of speculation and conjecture is required on the part of those whose duty it is to settle the dispute by choosing what seems to them to be the most

reasonable inference. Only when there is a complete absence of probative facts to support the conclusion reached does a reversible error appear. But where, as here, there is an evidentiary basis for the jury's verdict, the jury is free to discard or disbelieve whatever facts are inconsistent with its conclusion. And the appellate court's function is exhausted when that evidentiary basis becomes apparent, it being immaterial that the court might draw a contrary inference or feel that another conclusion is more reasonable."

Similar expressions with emphasis upon the jury's right to determine the credibility of the witnesses and the weighing of their testimony appear in *Sartor v Arkansas Natural Gas Corp.*, 321 U.S. 620, 627 (1943), *Aetna Life Ins. Co. v. Ward*, 140 U.S. 76, 88 (1891), and *Basham v. Pennsylvania Railroad Co.*, 372 U.S. 699, 701 (1963). A number of factual questions were integrated in the jury's verdict, including the question of petitioner's reliance, the question of petitioner's due diligence, and the question of respondent's intent or scienter. As set forth in the opinion of the District Court on the motions for judgment n.o.v., there were sufficient probative facts of record to support the jury's verdict under the legal standards set out in the District Court's charge to the jury.

In holding that there was "no showing" by petitioner "of the reliance required nor facts to meet the standard of due diligence on its part," the Court of Appeals simply ignored the evidence presented to the jury on these factual issues and summarily disposed of the same with the statement:

> " *** It is apparent that an earnings statement issued by a corporation at any but the expected time which shows any substantial change is bad news for someone who had been recently in or out of a fluctuating market." (App. E, p. 52a.)

The Court of Appeals' disposition of the factual issue of respondent's intent or scienter was premised on its characterization of the case as solely one of non-disclosure. In such a case, the Court of Appeals held that respondent had no duty to inform public investors of its drastically deteriorating earnings situation or take other action to protect the investing public, until respondent, in the good faith exercise of its business judgment, could develop verified figures which were ripe for publication. With respect to the factual issue of intent under this constrictive standard — Was there such a delay in releasing verified figures as to constitute bad faith? — the Court of Appeals concluded that "There was speculation and innuendo, but no facts." (App. E, p. 54a.) On the contrary, there were numerous facts concerning respondent's awareness of the rapidly deteriorating earnings picture at a time when it was in the process of bringing out a large issue of convertible debentures, by reason of which the Court of Appeals recognized a strong motive for delay. The jury's determination of the requisite scienter was based upon these same probative facts. As the District Court stated in his charge to the jury:

> "It is seldom, in a case involving deceit or an alleged deceit, that you have motion pictures of it, you know. You are almost always required to engage in this process of inference and deduction. And this case is no exception." (App. B, p.10a.)

The opinion of the Court of Appeals further obfuscated the factual issue of intent with an unwarranted implication that petitioner sought a negligence standard.[4] On the contrary, petitioner, in its brief and oral

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[4]The Court of Appeals stated: "We have considered the arguments that to move the standards entirely into the negligence field may likewise move the statutory basis for Rule 10b-5 out from under section 10(b) which has

(Continued on next page)

argument before the Court of Appeals, pointed out that notwithstanding the disagreement among the Circuits as to a definitive legal standard of scienter, none has required a claimant to satisfy a more onerous standard than the standard of willful, knowing, and intentional conduct applied by the District Court in his charge to the jury (App. B, pp. 13a, 14a-15a, 22a).[5] The District Court further instructed the jury that respondent could not be held liable if it had acted in good faith and explained that this was just another way of saying that it could not have had the required intent or scienter if it acted in good faith. (App. B, pp. 15a, 22a.)

In summary, the necessarily brief allusions to the evidence brought out in the trial below show that there were many and diverse facts produced for consideration by the trial jury which resulted in the jury verdict in favor of this petitioner. The facts were of a probative nature and the instructions of the trial judge as to the law to be applied to the facts were explicit and under-

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(Continued from preceding page)

no negligence language." In the proceedings before the Court of Appeals, reference to a negligence standard was made only in connection with the issue of the applicable statute of limitations, which was not decided.

[5]Professor Bromberg, in summarization of numerous cases, states: "No 10b-5 decision squarely requires 'intent to deceive' or clearly equivalent phrases. There are some dicta, some ambiguous statements, and some holdings that intent or knowledge (or recklessness) is necessary. Most of the cases are in the lower courts." Bromberg, *supra*, Sec. 8.4(543), p. 204.175. Bromberg also notes that the numerous holdings that some form of knowledge suffices for 10b-5 liability indicate that no particular form of motive or purpose is requisite for such liability, and that a 10b-5 violation can occur without economic motive or purpose if a false or incomplete press release is likely to influence the investing public. (Id., Sec. 8.4(554), p. 204,201.)

standable. The jurors, having observed the witnesses and heard their testimony, were in a position to discern the significant factors and, particularly, the subjective factors — a discernment which cannot be achieved by reading a reporter's transcript of the proceedings.

In the light of the matters set forth in this petition, the statements of the Court of Appeals as to the only issue in the case and the evidence relating thereto are untenable. The Court of Appeals said (App. E, p. 45a):

> "We are thus concerned only with the issue of the timing of the special statement on earnings."

Thereafter (App. E, p. 52a) is the statement:

> "However, there is nothing in the record other than speculation that the extent of the May loss could have been determined and translated into figures at an earlier date to develop a statement ripe for publication. The record thus shows without contradiction as to the defendant McDonnell Douglas as a matter of law that there was exercised good faith and due diligence in the ascertainment, the verification, and the publication of the serious reversal of earnings in May."

For the Court of Appeals to hold as a "matter of law" that there was an exercise of good faith and due diligence by respondent McDonnell Douglas is to ignore probative facts, whether in conflict or otherwise, and to usurp the solemn right of the jury to determine the truth of all the facts. Under the guarantees of the Seventh Amendment and the decisions of this Court, the verdict of the jury should not have been disturbed or preempted by the Court of Appeals.

CONCLUSION

For the reasons set forth above, petitioner prays that this petition for writ of certiorari be granted.

Respectfully submitted,

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APPENDIX A

United States District Court for the District of Colorado

Civil Action No. C-1257

FINANCIAL INDUSTRIAL FUND, INC.,
a Maryland corporation,
Plaintiff,

vs.

McDONNELL DOUGLAS CORPORATION,
a Maryland corporation, and
MERRILL LYNCH, PIERCE, FENNER
& SMITH, INC., a Delaware corporation,
Defendants.

and

McDONNELL DOUGLAS CORPORATION
Third Party Plaintiff,

vs.

INVESTORS MANAGEMENT COMPANY, INC.,
and ANCHOR CORPORATION,
Third Party Defendants.

Modesitt and Shaw, by Messrs. Leland E. Modesitt and Richard H. Shaw, Attorneys at Law, 1700 Broadway, Suite 1500, Denver, Colorado, for Plaintiff; Holland and Hart, by Messrs. James L. White, John F. Kelly and Edwin S. Kahn, Attorneys at Law, 500 Equitable Building, Denver, Colorado, for Defendant McDonnell Douglas Corporation; Holme Roberts & Owen, by Mr. Peter H. Holme, Jr., Attorney at Law, 1700 Broadway, Suite 1010, Denver, Colorado, and Brown, Wood, Fuller, Caldwell & Ivey, by Messrs. James B. May and Roger J. Hawke, Attorneys at Law, 70 Pine Street, New York, New York, for Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc.; and Winner, Berge, Martin & Clark, by Messrs. James A. Clark and Warren O. Martin, Attorneys at Law, 500 Capitol Life Center, Denver, Colorado, for Third Party Defendants.

MEMORANDUM OPINION AND ORDER

DOYLE, Judge

Plaintiff, a mutual fund, has instituted the present action seeking damages for alleged violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5 promulgated thereunder by the Securities and Exchange Commission, 17 C.F.R. §240.10b-5. The claim is that damage resulted from *first*, defendants' unlawful manipulation of the price of McDonnell Douglas stock and, *secondly*, from illegal use of inside information in connection with the purchase or sale of said stock. Defendants Merrill Lynch, Pierce, Fenner & Smith, Inc. (hereinafter referred to as Merrill Lynch) and McDonnell Douglas Corporation have both moved for summary judgment on the ground that there is no genuine issue as to any material fact and that they are entitled to judgment as a matter of law. F.R.Civ.P. 56(c).

Plaintiff makes the following allegations in support of its claims:

(1) Early in 1966, McDonnell Douglas began consideration of a refinancing program which would involve calling and retiring approximately $28 million of outstanding four per cent convertible debentures. Merrill Lynch was to act as agent of McDonnell Douglas in connection with the call of the outstanding debentures and the underwriting of the new debentures (success of the retirement program and success of a new offering depended on maintaining the price of the stock at a high level);

(2) Although the economic outlook for McDonnell Douglas in 1966 seemed rosy at the beginning of that year, its financial condition deteriorated substantially in the second quarter of 1966 due to increasing backlogs resulting from shortages of materials and skilled labor and also due to incorrect cost estimates on the production of DC-9 aircraft. Plaintiff contends that the public statements by McDonnell Douglas and Merrill Lynch as to the former's financial position failed to reflect this turn of events;

(3) Merrill Lynch supplied information about the true financial condition of McDonnell Douglas to favored customers prior to the public release of this information on the morning of June 24, 1966;

(4) On June 22, 1966 and June 23, 1966, plaintiff purchased 80,000 shares of common stock of McDonnell Douglas at $89.00 per share. Plaintiff made these purchases without knowledge of the true facts about McDonnell Douglas' financial situation. When McDonnell Douglas' financial picture was made public, the price of its common stock began to drop. Between July 1 and July 8, 1966, plaintiff sold its interests in McDonnell Douglas for approximately $65.00 per share, thus incurring a loss of $1,969,266.

Based on the above allegations plaintiff has described two alternative theories for recovery. *First*,

it is contended that McDonnell Douglas, by itself or in concert with Merrill Lynch, deliberately withheld from the public, including plaintiff, material information as to its economic condition and did so in order to manipulate the price of its stock. Plaintiff claims that this manipulation was undertaken in order that the common stock into which the four per cent debentures were convertible would be maintained at a level in excess of the conversion price stated in the debentures, thus allowing said debentures to be retired without cash outlay. *Second*, plaintiff asserts that the release of inside information by Merrill Lynch to its favored customers itself constituted a violation of Rule 10b-5 under the doctrine of *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

As to plaintiff's first theory, based upon manipulation of the price of McDonnell Douglas stock, we are of the opinion that there are disputed issues of material fact which render summary judgment inappropriate. For example, since private actions under Rule 10b-5 are in large part governed by the same tort principles applicable to fraud, intent to defraud or its equivalent, or *at least* knowledge that statements disseminated to the public are false or misleading, must appear from the evidence in order to make out a violation. Indeed, stock price manipulation imports a knowing course of conduct. *See, e.g., Trussel v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo. 1964). Generally, summary judgment is inappropriate where issues of motive, intent or knowledge are presented. 6 Moore's Federal Practice ¶56.174(41.-2). Defendants claim that the transactions which occurred between January 1 and June 23, 1966, as set forth in plaintiff's complaint, are insufficient on their face to support an inference that defendants intended to defraud or had knowledge that their informational releases to the public were false or misleading. We believe that the facts set forth in

plaintiff's complaint are such that reasonable men might differ on the inferences to be drawn from them with regard to intent and/or knowledge. Resolution of conflicting inferences is, of course, the duty of the trier of fact, and hence summary judgment cannot be granted. *See, e.g., Empire Electronics Co., Inc. v. United States,* 311 F.2d 175 (2d Cir. 1962).

The question of intent or knowledge is not the only disputed material issue of fact which remains. Also to be determined is whether Merrill Lynch played any part in any manipulation which is shown to have occurred. Further, the question whether plaintiff relied on any misrepresentations of the defendants or either of them is yet to be resolved.

Turning to plaintiff's second theory, the theory of tipping and insider trading, defendants contend that as a matter of law no claim for relief exists under the facts alleged by plaintiff. It is doubtful that tipping which results in insider trading on a national exchange can support a private action for damages under 10b-5. Where a corporation withholds material information from the public, a certain number of persons trading on the basis of insufficient information will be injured. This injury is not increased if corporate insiders who possess inside information are trading on the exchange at the same time. It is the incomplete information, not insider trading, which is the proximate cause of the damage to other investors.

Thus, the crucial question is when the corporation has a duty to disclose information to the public. As we read those cases involving private actions under Rule 10b-5, nondisclosure may constitute a violation of the Rule when it is part of a plan of manipulation or scheme to defraud. *See, e.g., Reynolds v. Texas Gulf Sulphur Co.,* 309 F. Supp. 548 (D. Utah 1970).

Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra, does indicate that the use of inside information may constitute a violation of Rule 10b-5. This and similar cases were, however, actions instituted by the Commission and hence the question of the causal connection between insider trading and injury to specific investors was not considered. Thus, these cases seem to be of limited applicability.

However, we need not determine finally at this time whether a claim for relief does or does not exist under the tipping theory. The existence of tipping, if proven, may in any event have some probative value in connection with the claim of manipulation, and thus plaintiff will undoubtedly wish to present evidence on the issue of tipping in any event. We reserve ruling as to the validity of the tipping theory until trial.

For the foregoing reasons the motions for summary judgment should be and the same are hereby denied.

The case will proceed to trial as scheduled commencing at 9:30 a.m. on Monday, August 17, 1970.

DATED at Denver, Colorado, this 13th day of August, A.D. 1970.

BY THE COURT:

/s/ William E. Doyle

WILLIAM E. DOYLE, Judge
United States District Court

APPENDIX B

Excerpts from Transcript of Proceedings in the District Court Setting Forth Charge to the Jury

THE COURT: Ladies and gentlemen, all of the evidence is in and the arguments have been completed and, of course, the Court will now charge you as to the applicable law. This will be an informal charge. Thus, you will not have a set of mimeographed instructions to take to your jury room. We do not operate that way here in Federal Court.

On the other hand, we do expect to delineate the issues and discuss them in a manner so that you will know just exactly what you have to decide. As best we can, we do it this way. And we also hope that, speaking to you informally, it will bring these matters home to you perhaps more clearly than it would if we were to read a long formal instruction to you.

In a case — every case — the jury, of course, has the sole function of determining the factual issues and of also determining the credibility of the witnesses; that is, the believability of those witnesses. And finally to overall decide the case.

On the matters of law, you are of course subject to the charge of the jury. It's the function of the Court to interpret the law and, as I say, to determine the manner in which it is — the form in which it is given to you. You are bound by the Court's determination as to the law and, as indicated previously, you must decide the case on the evidence and the law and those two things alone, uninfluenced by bias or prejudice, sympathy or any extraneous emotion.

What we seek to do then is to search out the true issues and search out the evidence. And ascertain what occurred. And apply the standards of the law to this fact situation and arrive at a verdict based upon those things, uninfluenced by personalities.

It is sometimes said the law is no respecter of persons. And by this is meant what I have just said: namely, that we are concerned with the issues in the case. This is our function. And you, as jurors, are judges pro tem, individually and collectively, and you must proceed upon this same basis, as I say, uninfluenced by what other people may think. After all, they have not heard the evidence. You have to learn early in this activity that you can't be concerned about your neighbor's viewpoints. You have to observe your own conscience and your own viewpoint as to what the evidence is and what the law is and that is the only way that the system can function with integrity and honesty. And, so, this is the way you must do it.

The fact that the lawsuit has been filed, the fact that corporations are involved, is not important. You must hear and determine and decide this case as if it were a contest between two persons of equal standing in the community. As I say, the fact that one party complains that they have been hurt is no evidence that the other party is guilty. You cannot — it is not possible for a juror to say, "Well, there must be something wrong here or the case wouldn't be in court." This is misconduct. I mean, you can't give any weight to the fact that a suit has been filed. It's a brand-new ball game, so to speak, once the case is in here. The pleadings simply furnish a framework within which we try the case, you know. It prevents going out of bounds, for example. And we study the case before trial. We have pretrial conferences in order to serve up these questions succinctly so we know exactly what evidence — not exactly, but to a large extent the theories of the case and the theory upon which a

recovery is sought. And so the pleadings do serve this purpose. They serve to establish some guidelines and boundaries so that we can finally decide the case with some degree — to determine it with some degree of efficiency. And, bringing the issues into clear relief, applying the evidence to these issues that have been developed and generated.

Now, much of the evidence here is circumstantial. There is nothing wrong with circumstantial evidence. It is unlike direct evidence. In the latter instance, the witness views the incident and comes into court and tells what happened, you know. And his version is then judged as to whether he saw it accurately or whether he's telling the truth. Circumstantial evidence, on the other hand, is somewhat different because it calls for the analysis of the facts and the drawing of an inference or conclusion or deduction from those facts. Thus, as applied to the instant case, you are called upon to examine a whole course of dealings over several months. What the parties did.

And what is the purpose of this? The purpose of it is to determine whether or not there was indeed a deceit in the sale of securities carried out. And so you have to draw deductions. In other words, were they acting honestly in this or were they suppressing information, for example. I don't say that's the only question. Was it designed to mislead? But these are the questions you have to ask yourselves as a practical matter when you view the exbibits and when you examine the testimony of the witnesses. And it has been — there has been quite a good deal of evidence, really, and it's in bits and pieces, as someone said. But this is the way of circumstantial evidence. Sometimes you get a strong circumstance which gives rise to a compelling conclusion, you know. Just no doubt about what occurred, even though

you didn't see it. A murderer may commit his murder in a locked room. But you hear the shot and you smell the smoke and when he comes out holding the gun, why, — and a person has been shot. Well, there is little doubt — you didn't see it, but the circumstances are so compelling that you can draw no other conclusion but that that person committed the atrocious act. Well, all circumstances are not of this grade, you know, and oftentimes they permit conflicting inferences, and you just have to weigh them and give weight to the one that is more logical, the more rational, the more reasonable. And this is what is meant by the evaluation of circumstantial evidence. And, as I say, this case is almost wholly a circumstantial evidence case.

By this, I don't mean that you should conclude that it's inferior at all. It is seldom, in a case involving deceit or an alleged deceit, that you have motion pictures of it, you know. You are almost always required to engage in this process of inference and deduction. And this case is no exception.

The burden is, of course, on the plaintiff, having brought the suit, to prove their case by what is called a preponderance of the evidence as to each and every allegation and element of it. They must establish by a preponderance of the evidence — it doesn't mean you have to count the number of witnesses each side produced. The evidence is that which is more convincing. And some of the evidence may originate with one party or another. But, ultimately, you have to decide which is the more convincing; which is the weightier, not in terms of number of witnesses or volume of witnesses presented at all, but that which appeals to you, your mind, as establishing the fact or not establishing it. And, as I say, you have to approach this with detachment.

Now, what is meant by a preponderance of the evidence? This means that the party having the burden of proof must establish his case to the level where it can be said — concluded that his thesis, that which he seeks to get you to believe, is more likely true than not true. So he must establish this case to the point where you say that the truth is here, at least to some degree. It is more likely here than not here. This is what is meant by burden of proof by a preponderance of the evidence.

You are called upon, as I told you a moment ago, to judge the credibility of witnesses; that is, whether they are telling the truth. In carrying out this most important function there are a variety of standards and criteria which you may apply. You can watch the witness on the stand, consider the demeanor of the witness in determining whether or not he is telling the truth. You may consider the interest which the witness has in the outcome of the case as bearing upon whether he is telling the truth, saying it accurately or whether he is coloring his testimony. These and many other standards and criteria you may consider. Is his testimony consistent as you hear it from the witness stand? Or is it inconsistent? This you may consider. Has he made prior statements out of court which are inconsistent with what he is saying now? All of these things and more you may consider. And if you determine that any witness has wilfully testified falsely you are at liberty to disregard the whole or any part of that witness's testimony. To disregard all of the witness's testimony would require a finding and a determination by you that the witness had wilfully testified falsely as to a very material matter whereby you can't believe him on anything else. This is a sanction that you would be slow and cautious to impose. At the same time, you may on occasion determine that a witness is exaggerating or coloring, and surely you can de-color or de-exaggerate it and arrive at the true facts, and this is what you must do.

Certain witnesses have testified as so-called experts. The law permits witnesses like medical men and accountants, engineers, to give conclusions regarding certain matters that are not within the purview of the lay person. Ordinarily we do not allow witnesses to testify to opinions and conclusions, that is, lay witnesses. But there are certain complex areas where we need expert testimony and this kind of testimony is perfectly legal and it comes into play, as you have noticed, by a preliminary set of questions designed to show that the witness has good qualifications, and finally a determination by the Court that he may testify to conclusions. You are not bound by the conclusions of an expert just because he is called as an expert or because the Court determines that he may testify as an expert. His testimony is subject to the same tests of credibility that I have just mentioned, those which are applicable to any other witness. At the same time, if you are convinced that the witness is testifying to accurate conclusions, you may give effect to his opinion and consider them in reaching your decision in the case.

As I indicated before, this is what is often described as an alleged fraud, only it's a specific type of alleged fraud, one which pertains to securities — federal securities. And it arises under a federal statute and that is why it's in federal court; the Securities and Exchange Act of 1934. The specific part of it is rule promulgated by the Securities and Exchange Commission, 10(b)(5), which declares that it shall be unlawful for any person by the use of any means or instrumentality of interstate commerce or the mails (or) any facility of any national security exchange, (1) to employ any device, scheme or artifice(sic) to defraud; (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made not misleading, or, (3) to engage in any act,

practice or course of business which operates or would operate as a fraud or deceit upon any person.

The plaintiffs here have invoked this; have brought this suit under it, alleging as to each of the defendants — and, by the way, you have to consider the elements of this as against each of the defendants individually. In other words, if you were to find that the evidence was adequate as to one, why, you wouldn't — it wouldn't follow that it's adequate as to the other. You have to consider them individually.

The elements of this is the burden of proof is on the plaintiff under this rule to prove, Number 1, that the device or artiface(sic) or scheme to defraud was employed or that, 2, there was an untrue statement of fact made which is deceptive or that there was omission to state the full facts or, 3, that there was a course of business engaged in which was deceptive in character and which operated as a deceit. And it must have been knowingly carried out, regardless of which section of 10(b)(5) the procedure is under; wilfully carried out, and not negligently. That would not be enough. It would have to be wilful and knowingly. And I will talk about that in a few moments.

The plaintiff must have been injured thereby. That is, deceived. This requires that there was a reliance upon it and an action in response to the deception, and finally, a loss suffered. These are the elements. The plaintiff must establish each and every one of these by a preponderance of the evidence. Should it fail to do so, should it fail to establish any one of them, you would have to resolve the case in favor of the defendant or defendants. And, as I say, it must establish them as against each of the defendants.

Now, in my judgment, ladies and gentlemen, the only provisions of this 10(b)(5) which come into play here are Parts 2 and 3; namely, the making of an untrue statement of a material fact or the omission to state a material fact, the giving of a half-truth; failure to state all the facts. I think this is what their theory is. Or the engaging in an act or practice or course of business — and this is virtually saying the same thing in a different way — namely, that there was a course of business carried out over a period of time which they — which had the purpose and the effect of making — giving out false information, positive facts, or withholding information whereby an untrue picture was the result. Thus, this defines — as I say, there is no act or practice or course of business other than that which they are relying on in terms of making untrue statements or making incomplete statements of half-truths. And so, as I say, it is somewhat repetitious. And so, basically, I think the case boils down, as I told you at the very outset here, to these crucial questions; first, whether there was a giving out of false information, or, secondly, whether there was a failure to give out the truth when it turned out that false information had been circulated, a failure to correct the facts. And I believe that that is what is involved here; that is, did they mislead the public — the defendants — by making positive statements which were false or did they hand out half-truths? And bear in mind that it is not enough to look at the results. It's all right to look backwards somewhat, but you have to gauge this by what occurred at the time and especially the intent of the parties.

Now, I have said to you that it is necessary for the plaintiff to prove that it was knowingly, wilfully, purposely carried out. What does this mean? This means that there was knowledge on the part of the defendants of the inaccuracy or untruth of what was being circulated and promulgated, that they nevertheless did it with knowledge of that fact. It doesn't require that there shall have been a diabolical design to cheat, you know,

but it does require that they knowingly and purposely and intentionally did it. For example, it served their own purpose — if you do decide that they knew the truth and they didn't tell it under circumstances in which there was a duty to disclose. There is a duty to disclose facts, based upon the circumstances. I don't suppose — sometimes it's private business — you don't have to disclose everything to the public. When you're in a public business, and it is dependent upon how widely public it is and how much the public is affected by it — I suppose the larger it is the more impact it has on the interests of the public, the more sensitive it is, the more obligation there is to disclose the truth to members of the public who are susceptible or who are likely to — who probably would be injured by the failure to advise what the truth is. There is also a duty to disclose, if you put out facts which later develop to your knowledge to be untrue, in this kind of a situation. Thus, you would have to correct them in order to satisfy this duty. On the other hand, bear in mind that you don't have to paint the bleakest picture possible in order to satisfy this. Surely, you have a corresponding duty to protect your own interests, and this law doesn't change that. You are entitled to, in the protection of the interests of your shareholders and of your institution, to present the truth in a manner that is favorable, if you do so without omitting facts or giving misstatements. There is where the line has to be drawn. And I think that the demarcation is clear when we talk about doing it knowingly and wilfully. This is what makes the difference. If you find and determine and are convinced by a preponderance of the evidence that there was a holding, that it was done purposely and intentionally, and if you determine that this was relied upon by the plaintiffs to their injury, why, the plaintiffs have made out their case as to — at least to part of it, that they are entitled to some recovery. We will come to the question of damages presently.

Before we do that, I wish to talk about this matter of reliance for just a moment. The plaintiffs must have been injured as a direct and proximate result of some wrongdoing on the part of the defendants. Thus, if the defendants commit a wrong in the abstract and the plaintiffs are unaffected by it, why, they cannot be blamed. In other words, they must establish that the alleged misinformation was the cause of their buying the stock, you know, that they actually relied on it; justifiably relied, is what the law requires. And that means reliance in fact and not reliance in their own judgment. I mean, if they made their own decision, knowing all the facts, why, they can't complain. So this is, along with the matters of omission and knowingly omitting or misrepresenting, this becomes a highly crucial issue in this case as to whether or not there was a reliance. It certainly — certainly the plaintiffs must establish that they did indeed rely on it and that this was the cause of the injury which they suffered. They must have believed the state of facts that they complain were false and must — you must be convinced that they did, and that they would not have purchased it had it not been for this belief. This, if you were convinced that they would have purchased regardless of whether or not — assuming that there were misstatements — regardless of whether they were made, why, then you would have to say that they didn't rely on it. They bought it on their own. They were not influenced by anything communicated by the defendants, whether it can be said to have been a positive statement or an omission of fact. Once again, if they made their own investigation — and there is some evidence that they did here — why, it must have been a reasonable investigation of facts that were apparent. And once they undertake it — in other words, I don't think the buyer in these circumstances needs to make any investigation. He can rely wholly on what the other person says. And then he's got a complaint. But if he undertakes to make his own check, why, then, whether he relied is open to question. In other words, if

he's making his own investigation, it's a question of whether he relied. But the fact that he undertakes an investigation doesn't mean that he didn't rely also on the statements of the seller. So, it is not conclusive at all.

Now, in determining this element of reliance, you are free to consider the level of knowledge of FIF, the plaintiff, and the amount of information they had; their ability to form a judgment. But this doesn't mean that because it can be said that they do have a research department and they are sophisticated that they are not to be protected by these laws the same as anybody else. As I say, you can just weigh this factor. But it's not conclusive. And if they were indeed misled, why, they have just as much right to complain about it as anybody else. As I say, I want to put that in place. That's all. And I think I'm obligated to do so because I think there has been a lot of emphasis as to their level of sophistication. And indeed you may consider it. But it's not the controlling factor. If you are convinced that they were deceived and acted in response to deception, in that event, why, they could of course recover.

Bear in mind that the plaintiffs have the burden of proof by a preponderance of the evidence that there was this deception and this reliance as well as the other elements I have already mentioned.

Now, one of the defenses which the defendants have asserted here is that there was what we might call an intervening cause at one stage of the proceedings, that there was an authoritative order on the part of an official of FIF to stop buying, that thereafter 23,000 shares were purchased. Should you conclude that indeed such an order was given and that it was authoritative, and there is some conflict on that, whether one man could stop it, but if you are convinced of this, that there was an — because there was an order countermanding the previous order, that it was not obeyed, then you are free

to determine that there wasn't reliance as to this last block of 23,000 shares, and there couldn't be any recovery. It's open to you to make this determination.

All right, now. I have talked to you about the elements of liability here. I now come to the question of damage. And it is my duty and obligation to talk to you about damages in the interest of completeness. By giving you an instruction on damage I'm not telling you to bring in any amount. I'm simply telling you if, and only if you determine liability, then you must consider the question of damages. Now, in approaching this subject be mindful of the fact that the purpose of the law is not to reward the good, so to speak, and to punish the bad. No, the only object of a lawsuit is to bring about imperfect restitution. In other words, if someone has been injured at the hand of another, why, the suit seeks to restore the plaintiff to the condition that he was in before it happened. And that's the whole theory and philosophy of damages. In other words, we do not award damages because we think one side should be punished or the other side is entitled to be rewarded.

All right. Bearing that in mind, if you conclude that you should return a verdict in some amount, then the way to approach this is to examine the figures and the formula which is generally approved in this type of case and that is what is called out-of-pocket loss. And it awards to the plaintiff the difference between the price he paid for the item involved and the reasonable market value at the time of the purchase. And so you have to make this determination. The market quotation would not be conclusive. But it is the value as of the time, had the true facts been known, you know. What would it have sold for reasonably? What was its actual value at the time, as opposed to the amount they paid? They are entitled to this difference to the extent that you conclude that they have been injured by the defendants, if you do make that

determination. And in deciding what the actual worth of it was on the date in question, you just have to consider all the facts and circumstances and make your own decision. I pointed out before that there are two aspects here. There are two different purchases. And that one — as to the 23,000 shares, of course, there is a complex fact situation here which you must resolve before you reach this point. Now, bear in mind that I am not, by telling you what the rules are in connection with the award of damages, I am not telling you that you should award any amount. But if you do award damages or determine that it should be awarded, how you are to proceed in making such an award. So, therefore, to recap this, and to do so very briefly, this is a case arising out of the Securities Act in which you must decide whether the defendants through a course of dealing or through specific acts misled the public and the plaintiffs as members of the public by making false — issuing false statements, false and misleading statements; or neglecting or — or knowingly failing to reveal the true facts once they knew them, whereby the plaintiffs, as buyers of a security, were misled, were deceived, relied upon the information given, or they failed to give, to their injury and to their damage. This is what it amounts to.

And then, if you resolve in favor of the plaintiff, then you have to grapple with this question of damages, as I told you before, determining the difference between the price paid and its actual worth at the time, had the true facts been known. Now, I'm about finished here. It's about time, too.

As I indicated to you before, there is no requirement in logic that you — or consistency — that you find both the defendants responsible. You could find one or more. You could single them out because different evidence applies to each of them.

I have emphasized that, as the trial has gone along,

that certain evidence was offered and was received as against one of the parties or the other. So really a different body of evidence is applicable. Sometimes it's a — sometimes it applies to both, but oftentimes it applies to one and not to the other. So you must figure the evidence in that light. You will recall that during the trial counsel oftentimes made the point that the evidence had nothing to do with them and you were instructed to disregard it as to that party. Well, you must bear this in mind when you make your final determination. As I say, there is no requirement in logic or consistency that you arrive at the same verdict as to each. But the amount of your verdict as to each defendant would have to be the same, as I view it. In other words, you can't decide that one caused a certain amount and one another if you were to decide against both. The plaintiff is only entitled to one recovery. In other words, you can't split them up and say, "Well, we will charge one party so much and another party so much." It's a joint verdict as to the amount. The plaintiff's loss is so much. And it can't be any more, regardless of cause. And, as I say, the plaintiffs are only entitled to one recovery. Bear that in mind. So, whether you award — if you do award any amount — and I'm not saying you should — but it would be against both of them. But the plaintiffs would only recover that amount, whether they got it from one or both. You're entitled to know this; that these are the mechanics of how it works. And you have to know that or you could make a mistake in making your determination.

Now, when you retire you will elect one of your number as foreman and he or she will preside over your deliberations. And, when you have unanimously agreed upon a verdict, the foreman will sign your verdict and you will come into court and deliver it to the marshal for a public announcement. Your consideration is limited to the evidence. And bear in mind that the statements of counsel are not evidence. This is not to say that the

lawyers do not perfrom an important service. They do. They present the case. They present it in a manner that — whereby it can be understood. They argue it from the record that has been developed. And, to the extent that their arguments are logical and reflect the evidence in the record and the law of the case, why, you are free to utilize this. But this doesn't mean it is evidence. They're not offering anything independently.

Similarly, the statements of the Court made during the trial are not evidence in the case. Questions asked by the Court have no particular significance. Sometimes it's to clarify something. Sometimes it's a question that both sides are apprehensive about asking but that probably should be asked in the interest of clarifying the point. Bear in mind that it doesn't indicate whatsoever that the Court is siding whatever. It's only in the interest of developing the evidence and the facts. And so keep it in mind. I don't say that you would be influenced by any attitude that you consider the Court might have in the case. I don't say that you would. But it is my duty to tell you that it must not be. It is your responsibility to decide the case uninfluenced by anything that you may think the Court might be thinking about the case. Be sure that there isn't any viewpoint. So it's your responsibility. You must exercise it. I'm sure that you will to the very best of your ability.

I reiterate again that anything in the nature of bias or prejudice, personalities — they are just foreign to the administration of justice; the antithesis of it. Just can't have it. I mean, (it sullies) justice if there are any personalities involved. It doesn't matter who one is or what he has done, you know. Just keep it in mind. We're seeking out the truth as far as the facts are concerned. It's a search for the truth. It's equity and, as conscientiously as we can, to ascertain what the law applicable is, and that's the way we administer justice and that's the way it has to be. When you have done it in this man-

ner you have given it your best effort and you will have no regret whatsoever. That's all anybody can ask you to do.

Do you want to be heard?

(Colloquy among counsel and Court omitted.)

THE COURT: Now, ladies and gentlemen, we're about finished. I did neglect to mention some things I had determined I would say and these are quite brief.

In speaking to you about burden of proof in a case involving deceit, generally, I said that the burden of proof is by a preponderance of the evidence. And this is quite true. Sometimes it is said by the courts that evidence in a fraud case must be clear and convincing. And that is true. It doesn't change the burden of proof. In my judgment it requires the trier of the fact, whether it be the Court or the jury, to consider the evidence in a guarded and sober reflective manner, bearing in mind the seriousness of the charge and being certain that you are convinced of the truth of the charge by a preponderance of the evidence.

I also had determined to mention something about good faith of the defendants. If this is present, of course, there can be no recovery against them if they at all times acted in good faith. But, as I view this, it means that they didn't act fraudulently. They didn't act wilfully and knowingly and purposely to put out false information which would probably injure another. But it's just another way of saying that, if they acted in good faith, they didn't act with the requisite intent.

All right. Now, finally, I wish to add to what I said about the lawyers' statements not being evidence. They do have a complex mission, and that is to help you. At the same time, they are seeking to advance the interests

of their clients as well, and they do a good job. And don't be intolerant of their efforts because it sometimes looks easy, viewed from here or from there. It's really very hard, when they have hundreds of documents to keep track of and small pieces of evidence to know about and, as I say, they do very well, and I'm sure you will judge their efforts in this kind of spirit.

All right. Now, as I say, the case is submitted to you. You may discuss it among yourselves freely and when you have arrived at a verdict, why, let us know.

Will you please swear the marshall.

(Marshal sworn.)

THE COURT: Now, forms of verdict pertaining to the plaintiff against Merrill Lynch and the plaintiff against McDonnell Douglas are being furnished to you for your convenience. There is a verdict for the plaintiff and one for the defendant in each instance. The order in which they are given to you has no significance whatsoever. You will have all the exhibits in your jury room and as soon as you get there, why, they will be put together and checked over first and submitted.

All right. You may now retire.

APPENDIX C

In the
United States District Court
for the District of Colorado

FINANCIAL INDUSTRIAL FUND, INC.
a Maryland corporation,
Plaintiff,
vs.
McDONNELL DOUGLAS CORPORATION,
a Maryland corporation, and
MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
a Delaware corporation,
Defendants.

Civil Action No. C-1257
JUDGMENT

THIS MATTER having come before the court on August 17, 1970, for trial to jury of twelve persons, the Honorable William E. Doyle, Judge, presiding, the matter having proceeded to trial and having been duly submitted to the jury on August 27, 1970, and the jury having duly rendered its verdict on August 28, 1970 in favor of the plaintiff and against the defendants, McDonnell Douglas Corporation and Merrill Lynch, Pierce, Fenner & Smith, Inc., in the amount of $712,500.00, it is, therefore,

ORDERED that the plaintiff, Financial Industrial Fund, Inc., have and recover from the defendants, McDonnell Douglas Corporation and Merrill Lynch, Pierce, Fenner & Smith, Inc., the sum of $712,500.00, together with interest as prescribed by law. It is further,

ORDERED that the plaintiff shall have and recover from the defendants its costs upon the filing of a Bill of Costs with the Clerk of this Court.

DATED at Denver, Colorado this 15th day of September, 1970.

/s/ William E. Doyle
WILLIAM E. DOYLE, JUDGE

APPENDIX D

In the United States District Court for the District of Colorado

Civil Action No. C-1257

FINANCIAL INDUSTRIAL FUND, INC.,
a Maryland corporation
Plaintiff,

vs.

McDONNELL and DOUGLAS CORPORATION,
a Maryland corporation, and
MERRILL LYNCH, PIERCE, FENNER
& SMITH, INC., a Delaware corporation,
and *Defendants.*

McDONNELL and DOUGLAS CORPORATION
Third Party Plaintiff,

vs.

INVESTORS MANAGEMENT COMPANY, INC.,
and ANCHOR CORPORATION,
Third Party Defendants.

Modesitt and Shaw, by Messrs. Leland E. Modesitt and Richard H. Shaw, Attorneys at Law, 1700 Broadway, Suite 1500, Denver, Colorado, for Plaintiff; Holland and Hart, by Messrs. James L. White, John F. Kelly and Edwin S. Kahn, Attorneys at Law, 500 Equitable Building, Denver, Colorado, for Defendant McDonnell Douglas Corporation; Holme Roberts & Owen, by Messrs. Peter H. Holme, Jr. and Donald C. McKinlay, Attorneys at Law, 1700 Broadway, Suite 1010, Denver, Colorado, and Brown, Wood, Fuller, Caldwell & Ivey, by Messrs. James B. May and Roger J. Hawke, Attorneys at Law, 70 Pine Street, New York, New York, for Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc.; and Winner, Berge, Martin & Clark, by Mr. James A. Clark, Attorney at Law, 500 Capitol Life Center, Denver, Colorado, for Third Party Defendants.

MEMORANDUM OPINION AND ORDER

DOYLE, Judge

I

THE MOTIONS

Defendants have moved for judgment notwithstanding the verdicts and for a new trial. There have been oral arguments on these motions followed by extensive briefs submitted by all sides — the last one having been filed December 31, 1970. We have carefully considered the entire file and have given careful study to all of the contentions. The entire matter now stands submitted and ready for decision.

Several contentions have been raised in the motions, but the chief of these are:

1. Inadequacy of the evidence to establish misrepresentation or nondisclosure or deceptive acts or practices.

2. Insufficiency of the evidence to establish scienter.

3. That as a matter of law there was not reliance by plaintiff since the transaction was not a face to face one, but rather involved purchase of 80,000 shares of Douglas Aircraft stock on the stock markets — New York and West Coast; that as a result plaintiff was outside the orbit of liability. It is argued that plaintiff was not shown to have been looking directly to the representations of Douglas Aircraft and Merrill Lynch, but rather was at best relying on the allegedly generally optimistic posture of Douglas which had been presented to the public.

II

THE NATURE OF THE CASE

This suit has been prosecuted pursuant to Section 10 of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission, especially parts 2 and 3 thereof.

Commencing on June 22 and 23, 1966, plaintiff mutual fund, following a decision to acquire 100,000 shares of Douglas Aircraft stock, proceeded through its trader to acquire it through market purchases. On June 22, 1966, a total of 53,000 shares were purchased by the Financial Industrial Fund trader. The following day, June 23, 1966, 27,000 additional shares were obtained. The purchase price averaged out at $89.00 per share. The additional 20,000 shares were not purchased on the 23rd largely because of the market activity as of that time. A large number of Douglas shares were then being offered for sale, and because of this, plus the likely decline in the price, one broker actually refused to sell additional shares to plaintiff. There was evidence that one Financial Industrial Fund officer had ordered that there be no further purchases after the first 53,000 shares were obtained. The additional 27,000 shares were nevertheless purchased. The next day, June 24, Douglas disclosed that its earnings in the fiscal year 1966 would be nil.[1] Following this announcement the price of the shares declined drastically. The decision was then made by Financial Industrial Fund to sell all of the stock which had been acquired. The resultant loss amounted to approximately two million dollars.

This was a jury trial in which verdicts were awarded to the plaintiff in the sum of $700,000. In passing on

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[1]Not only were there no earnings in the year 1966, the losses for that fiscal year were very substantial.

these motions we do not deem it necessary to recount the evidence in detail or to enter findings of fact and conclusions of law; it will be sufficient to comment briefly on the legal points raised, at the same time generally outlining the factual structure of the case.

III

OUTLINE OF THE EVIDENCE

The evidence was to a large degree circumstantial, most of the circumstances being offered to establish knowledge, intention and motive of the defendants in not disclosing the facts until June 24, 1966, the day after plaintiff's purchase and loss.

The Douglas financial problem was not the result of a shortage of business or orders. In fact, Douglas had too much business — its backlogs ran into the billions of dollars. Its difficulties arose from inability of the aircraft division to complete and deliver airplanes. This in turn was attributable to unskilled labor troubles and sub-contractor difficulties. The total effect was acute shortage of cash during the fiscal year 1966. This necessitated going to the public for financing. It was basically this condition which led to the loss of earnings and the decline in the price of Douglas stock.

At the start of the fiscal year 1966, on or about December 1, 1965, Douglas had outstanding some 28 million dollars in four percent convertible debentures. Because of the need for more working capital (cash) it was decided in early 1966 to call these debentures and to issue new ones in the amount of at least 50 million dollars. It was later decided that this amount should be increased to 75 million dollars in new debentures. Merrill Lynch was not only the chief underwriter for Douglas, it also proved to be a financial consultant and close associate. Merrill Lynch participated in the

decision to recall the old debentures and to issue new ones and participated as well in the actual carrying out of these efforts. The 28 million dollars in debentures were recalled in April 1966, at which time 99 percent of these were redeemed for common stock at a price of $77.00 per share, an amount which was below the then market price of the stock. For the call to succeed it was important to maintain the price of the stock at a higher level than the conversion price,[2] and during this period and the quarter preceding, dividends were paid and glowing projections were made by both defendants for the future earnings of Douglas.

During the next month, May 1966, the Douglas problems started to mount and become apparent to them and to Merrill Lynch as well since the latter maintained a close surveillance of the Douglas conditions. The problems were manifest from rising cost estimates and inventory write downs. Nevertheless, during the month of June, and up until June 24, the *public* disclosures consistently heralded substantial earnings for the first six months of fiscal year 1966 and, indeed, for the entire year.

On June 7 there was issued a preliminary prospectus pertaining to the 75 million dollar debenture issue (which was contemplated for July 1966). This so-called red herring prospectus showed earnings for the first five months of 1966 of 85 cents per share. During the next week the earnings estimate receded to 76 or 78 cents per share, and on June 14 the accounting department of Douglas concluded that a substantial inventory write down of 3.7 million dollars should be taken. This would have resulted in earnings of 12 cents per share for the six months ending May 31, 1966. Mr. Douglas, the President, testified at the trial that he had, during the

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[2]Merrill Lynch had agreed to redeem at least a part of these debentures for cash if it became necessary for it to do so.

period June 14-17, heard a 14 cent figure which he regarded as preliminary. Thereafter, an estimate of 49 cents per share was reported and, finally, the evidence of Douglas showed that on the 23rd of June a firm figure of 12 cents per share came out of the audits and reaudits. After this a press release to this effect was issued on June 24, and it was this release which triggered the decline in Douglas stock which in turn produced the plaintiff's loss. It is true as defendants contend that some signs or symptoms of the Douglas difficulties might have been apparent to the public prior to the 24th. However, none of these were sufficient to disclose the depth of the Douglas problems.

As to Merrill Lynch, the evidence established that its officers were in constant touch with Douglas personnel, and a few days before the decline of Douglas Mr. Donald Douglas offered Merrill Lynch an opportunity to withdraw as underwriter. Merrill Lynch did not take advantage of this opportunity. On the contrary, Merrill Lynch not only stayed in but was, in the last days, admittedly responsible for the information leaks which produced the rash of selling. The leaks produced rumors and gossip, but these were not all. Merrill Lynch agents tipped Merrill Lynch customers, and this also contributed to the wave of selling which coincided with Financial Industrial Fund's purchases.

In the above statement of the record, we have not detailed all of the facts, but have set forth material from which it was possible for the jury to conclude that primarily Douglas Aircraft, and secondarily Merrill Lynch, had facts within their knowledge as to the true state of the Douglas internal affairs. The jury could also conclude that having issued optimistic reports designed to maintain the market price of the stock, the defendants were equally obligated to correct the misapprehensions which existed as late as the 22nd and 23rd of June.

The defendants take the position that since their officers did not come face to face with actual verified numbers that they cannot be held responsible for withholding information. However, this is not and should not be the test of actual knowledge. The question is whether the circumstances were sufficent so that the trier of the facts can justifiably determine that they, and hence the respective companies, were aware of the true conditions.

It is to be made clear that the evidence does not support a finding that the officers of the defendants were guilty of fraud in any onerous or diabolical sense. Thus, there was not an intent to cheat such as is present in income tax fraud or mail fraud, but such an intent is not necessary in a 10b-5 case. The defendants were engaged in the advancement of their own interests and in doing so subjected the buying public, including the plaintiff, not only to an unreasonable risk of harm, but even worse, their activity, in the judgment of the undersigned, at least, was reckless and injury was not merely likely — it was highly probable. Where as here there exists a strong probability that harm may result even though the perpetrator may hope that it does not, but he nevertheless persists in the course of conduct, the act is more than negligence, it is in reckless disregard of the rights of others. *Restatement of Torts Second,* Section 500, Comment f.

In summary then it was open to the jury to conclude from the evidence:

1. That there was an underlying motive for both defendants to withhold the facts and postpone the inevitable so as to first redeem the old debentures and, secondly, to market the new issue. They were also motivated no doubt by the hope that some miracle would save Douglas.

2. Both Douglas and Merrill Lynch were aware from the evidence which was presented that the problems of Douglas were severe and that the earnings picture was fast deteriorating and that when this became public, the Douglas shares would decline substantially. The knowledge of Merrill Lynch was evident from the circumstances and also from its leaking and tipping.

3. The initial optimistic reports and the withholding of the bad news violated the duty owed by both defendants.

4. Plaintiff would not have purchased if the facts had been announced. Thus, defendants' conduct was the cause of plaintiff's loss.

The duty of Merrill Lynch to disclose to the public in these circumstances is less clear than that of Douglas. This is not to say though that no duty existed for Merrill Lynch. In view of the demonstrated complicity between the two, and considering the fact that Douglas was a large corporation living in close proximity to the public and Merrill Lynch occupies a similar position and is or should be acutely aware of consequences of non-disclosure, it cannot say that it owed no duty to reveal the facts — that this was up to Douglas as principal. Merrill Lynch did, after all, communicate the facts internally and privately.[3] If its first duty was to Douglas, and we doubt this, it would and should have terminated the relationship.

IV

THE QUESTION OF RELIANCE

It is urged by both defendants that the plaintiff was a remote purchaser and was not looking specifically to

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[3]To be sure, the disclosures were not widespread and were not shown to be Merrill Lynch policy.

defendants. Hence, the element of reliance was not proven.

Defendants rely on the Tenth Circuit decision in *Reyos v. United States*, 431 F.2d 1337 (10th Cir. 1970), which case held that reliance is required in a 10b-5 case. The court observed that *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965) "does not hold that reliance is not required, as the plaintiff urges. It is a basic element of a cause of this nature, and was there shown." The Court of Appeals continued:

> In the case before us the facts of misrepresentation have been shown as to several of the transactions. The record, however, does not contain any evidence relating to reliance by the plaintiffs on the representations of the defendants Gale and Haslem. This is a necessary element of the cause alleged. List v Fashion Park, Inc., 340 F.2d 457 (2d Cir.), considers, defines, and requires both materiality of the representations and reliance. See also, 16 U.C.L.A. L. Rev. 404; 63 Nw.U.L. Rev. 434.

The reliance test set forth in *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.) cited by the Court of Appeals in *Reyos* is "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact." The *List* court is thus talking about the causal factor rather than reliance which traditionally existed in the common law action of fraud and deceit. This rigid approach to reliance which was enunciated in the English case of *Peek v. Gurney*, L.R. 6 Eng. & Ir.App. 377 (1873) is no longer observed even in fraud cases. W. Prosser, Law of Torts, 717-18 (3d Ed. 1964). The author, in discussing cases in which scienter rather than negligence is required (and the instant case is of that nature), states:

> (T)here is a very definite tendency to depart from the old position, and to extend liability to those whom there is no desire to influence, but whose reliance upon the representation there is any good reason to anticipate. , , , Beyond this, the same result sometimes has been reached by finding that that was "intended" which was merely foreseeable. . . . The limitation to a "desire" to influence the plaintiff seems clearly too narrow. . . . *Id.* at 718-19.

In view of the above we disagree with defendants' position that the *Reyos* case establishes an invariable actual reliance requirement. Rule 10b-5 does not specify or define any particular type of reliance. It requires that the fraudulent act complained of be performed "*in connection* with the purchase or sale of any security." What *connection* is necessary has been variously defined by the cases, and indeed in an early case decided in 1951, Judge Sugarman (now Chief J.) held that there must be a semblance of privity between the vendor and purchaser of the security. *Joseph v. Farnsworth Radio & Television Corp.*, 99 F. Supp. 701, 706 (S.D.N.Y. 1951), aff'd 198 F.2d 883 (2d Cir. 1952). However, the privity requirement seems to have all but disappeared and at the present time reliance and causation are frequently used interchangeably. *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (1969); *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied sub nom. List v. Lerner*, 382 U.S. 811 (1965).

The current thinking is that privity is not an indispensable requirement and that open market transactions such as that at bar are not on that account lacking in the elements of connection or reliance. *Cochran v. Channing Corp.*, 211 F. Supp. 239, 245 (S.D.N.Y. 1962). In *Cochran*, which is regarded as a very thorough judicial analysis of the problem, it was recognized that the absence of privity is a factor to be considered in making a

determination. So also Professor Loss believes that privity, although not essential, is at the same time not irrelevant. 6 Loss, Securities Regulation 1395-96 (1969 Supp.). He discusses the relevance of the absence of privity as follows:

> For example, however unfashionable the distinction between misfeasance and nonfeasance, we have seen that the market buyer or seller *should* find it harder to recover against the issuer or its insiders *who have not themselves sold or bought* (or acted to manipulate the market or to induce the plaintiff to buy or sell) when the plaintiff is complaining of a *failure* to disclose than when he alleges a misleading report of some kind. See p. 3597 supra. Again, it should perhaps be relevant, in assessing the significance of the absence of privity, whether the gravamen of the 10b-5 complaint is intentional misconduct — in which event a sufficient limitation on liability may be afforded by the concept of reasonably foreseeable consequence — or negligence. See Comment, Civil Liability under Section 10B and Rule 10B-5 (sic): A Suggestion for Replacing the Doctrine of Privity, 74 Yale L.J. 658, 667 (1965); cf. (1963) Duke L.J. 796, 806.

6 Loss, *supra* at 1396.

Professor Bromberg also considers the presence or absence of privity to be a part of the inquiry and evaluation. He states that the abandonment of privity does not

> mean one can recover from just anybody, or even force him to trial without alleging some significant connection with the violation. The successfully stated causes of action for open-market

transactions have been mainly (a) against issuers, where some kind of relationship exists through security holding, whether we call it privity or something else, or (b) against controlling persons or insiders, where there is a similar but perhaps more attenuated link. Nonprivity causes of action have also been stated against stock exchanges where violations occurred and against accountants failing to disclose after-acquired information which showed the falsity of financial statements they had previously certified. Such situations raise the question. . . whether gain or benefit by the defendants is essential to the violation. Apparently it is not, although its absence may affect the measure of liability.

There has not yet been a *recovery* by an open-market buyer against an open-market seller or vice versa. We are a long way from holding that the TGS official who used inside information to buy 600 shares the day 440,000 traded is liable to all the sellers. The mechanism which will measure and channel his liability is not yet forged.

A. Bromberg, Securities Laws: Fraud — SEC Rule 10b-5 § 8.5, at 208-208.1 (1969).

Bromberg has collected numerous cases in which courts have held that privity is not essential.[4]

Our conclusion is then that both reason and authority support the view that the open market situation does not preclude the presence of reliance. The court must, however, be guarded in reaching a conclusion that the essential connection has been satisfied. No one test

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[4]See Bromberg, *supra*, n.30 at 205-06. See particularly the discussion by Judge Daugherty in Geo. H. McFadden & Bro., Inc. v. Home-Stake Production Co., 295 F. Supp. 587, 589 (N.D. Okla. 1968).

would seem to be sufficient. It calls rather for a general inquiry as to whether there was both a factual and legal connection. Both the "but for" and "substantial factor" tests can be used as well as the extent of foreseeability or probability of a result similar to that which occurred. Furthermore, the size and relationship of the defendants and their proximity to the public should also assume importance on the question whether there was a duty to disclose to the public at large. In the light of these considerations we are of the opinion that the requisite reliance or connection in our case is sufficiently established.

It is concluded that the defendants' motions should be and the same are hereby denied.

DATED at Denver, Colorado, this 27th day of January, A.D. 1971.

BY THE COURT:

/s/ William E. Doyle

WILLIAM E. DOYLE, Judge
United States District Court

APPENDIX E

United States Court of Appeals

TENTH CIRCUIT

JANUARY 1973 TERM

FINANCIAL INDUSTRIAL FUND, INC., a Maryland corporation, Plaintiff-Appellee, v. McDONNELL DOUGLAS CORPORATION, a Maryland corporation, Defendant-Appellant.	)	No. 71-1387 No. 71-1388 No. 71-1389 (D.C. #C-1257)

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLORADO

Edwin S. Kahn, Denver, Colorado (James L. White, John Fleming Kelly, and Bruce W. Sattler, Denver, Colorado, and Holland & Hart, Denver, Colorado, of counsel, with him on the Briefs), for Defendant-Appellant.

Leland E. Modesitt, Denver, Colorado (John J. King, Jr., Ward E. Terry, Jr., and Richard H. Shaw, Denver, Colorado, with him on the Briefs), for Plaintiff-Appellee.

Before LEWIS, Chief Judge, HILL, SETH, HOLLOWAY and BARRETT, Circuit Judges, sitting en banc (McWILLIAMS and DOYLE, Circuit Judges, having recused themselves).

Per Curiam.

The plaintiff, Financial Industrial Fund, Inc., a mutual fund or management investment company, brought this damage action against McDonnell Douglas Corporation, and against the underwriter of Douglas, Merrill Lynch, Pierce, Fenner & Smith, Inc. The action is based on Rule 10b-5 of the Securities and Exchange Commission. Trial was to a jury which rendered verdicts against the defendants in the amount of $712,500.00. An appeal was taken initially by the several defendants, but the appeal as now perfected concerns only the plaintiff and the defendant, McDonnell Douglas Corporation.

The defendants moved for directed verdict at the close of plaintiff's case and at the close of defendants' case. These were denied. The defendants also moved for judgments notwithstanding the verdict and for a new trial. These were also denied.

Certain corporate changes in Douglas took place following the events here involved, but these are not significant for the purposes of this opinion. The defendant-appellant was engaged at the pertinent time in the manufacture of aircraft, and of various vehicles and systems for the space program.

The events which gave rise to the complaint relate to the purchase by Financial Industrial Fund of shares of the common stock of Douglas. A decision by plaintiff to buy 100,000 shares was reached on June 21st, 1966, and the actual purchases in the open market or over the counter began early in the morning of June 22nd. That morning by 9:15 a.m., Denver time some 57,000 shares were bought. Plaintiff's officer who was instrumental in reaching the decision to buy was surprised at the large number of shares offered, and he ordered that purchases stop. Nevertheless some 23,000 additional shares were purchased the following morning of June 23rd. No purchases were made from Douglas or Merrill Lynch.

On June 24th plaintiff heard of the announcement to the press by Douglas that its earnings for the last six months period were twelve cents per share. The issues in this appeal center around this special earnings statement. This earnings figure for the period was far below estimates made by independent market analysts and brokers prior to such date and known to plaintiff. The plaintiff had not consulted with Douglas or Merrill Lynch before the purchase. The regular quarterly earnings statement for Douglas was not due until its scheduled time in mid-July. This fact was known generally to investors including the plaintiff. The public markets reacted to the special earnings statement of Douglas of June 24th by beginning a substantial decline. Plaintiff then contacted Douglas and engaged a market specialist to analyze the position of Douglas. Plaintiff on June 30th reached a decision to sell the shares of Douglas and the 80,000 shares were sold between July 1st and 8th for a price substantially below the purchase price.

The appeal presents no issues concerned with any direct purchase and sale of stock between Financial Industrial Fund and Douglas, nor any issue of inside dealing or of "tipping" by Douglas. The plaintiff is in the position of any purchaser in the open market, and the information with which the case is concerned was public information. The plaintiff being a mutual fund is in the business of making money by the investment of the money of others, and as such holds itself out as an expert or professional as to investments.

The case was originally heard by a panel of this court, but it was decided to hear the case en banc with the parties to give particular attention to the issues herein treated. It was necessary for two judges to recuse themselves from hearing the case en banc. In view of the fact these two judges cannot participate, and in view of the inability of the panel to agree on the issue as to the proper statute of limitations to apply, that issue is not

here decided. It is expected that the issue of which limitations period to apply will again arise in the near future in an interlocutory appeal, and a full court then can act.

The record shows that on May 27, 1966, the president of Douglas was advised that the Aircraft Division of the company was experiencing delays in deliveries by its suppliers of components, and that the work force was not as efficient as had been expected. A group of corporate officials was sent to determine the extent of the problems, and it reported back on May 31st that the delivery of some eighteen airplanes in the process of assembly could not be made until the next fiscal year. On June 1st an announcement of the delay was made to the press. This concluded with a statement that earnings for the fiscal year would be adversely affected.

The company had just completed the call of existing convertible debentures, most of which were converted to common stock as the prevailing market price of the stock made it favorable for the holders to so convert. On June 1st the directors approved the issuance of new debentures with Merrill Lynch as the underwriter. In connection therewith, a preliminary prospectus was soon prepared and issued (June 7th) which showed the first five month earnings (December through April) to be slightly below the same period for the prior fiscal year. The quarterly financial analysis was underway as was an evaluation of the stages of completion of some 381 airplanes in the process of manufacture.

Profit figures from the Aircraft Division were given on June 14th to an officer in the comptroller's office who was assembling the data for regular financial reports. These figures showed a loss for the division of several million dollars for the month of May. This official and the company comptroller went the next day to discuss the matter further at the Aircraft Division and decided

to call in the company's outside auditors for consultation as to whether inventory revaluations should be made under the circumstances. On June 17th the president of Douglas sent fifty to seventy engineering, estimating, and accounting officials to the Aircraft Division to investigate the situation. This group reported back on June 20th that the expected six months earnings figure for the entire company would be about forty-nine cents. Meetings with the outside auditors to consider the finding were held on the next day and the day following. After the second meeting on June 22d it was decided that a substantial inventory writedown was required in view of the losses, and this would reduce the six month earnings figure from the forty-nine cents previously reported to the president to a figure of twelve cents. The president then on the next day ordered a press release to be prepared relating to the earnings so determined for the past six months. This was done the same day in time to be made public before the opening of the New York Stock Exchange on June 24th. The market price of Douglas stock declined $2.75 per share to $76.00 on the 24th. By the time plaintiff had sold its shares of Douglas in question (July 8th), the stock closed at $64.50 per share.

The record showed that the market price of the common stock of Douglas fluctuated in its fiscal year of 1965 between $71.75 and $24.50 per share, and in the following fiscal year to June it fluctuated between $108.61 and $68.68. Earnings also fluctuated widely over the same period and prior thereto, as did annual gross sales. At the time in issue, Douglas had a backlog of orders for airplanes which was substantial.

Defendant Douglas argues that the elements of an action under Rule 10b-5 were not shown. Specifically, defendant urges that the plaintiff failed to show facts to meet the scienter standards or requirements, which were applicable to a complaint alleging a failure to issue the special earnings statement at an earlier time. Defendant

urges that under the evidence the trial court did not apply the correct standard in ruling on its motion for a directed verdict and judgment n.o.v. Defendant also urges here that incorrect instructions were given by the trial court relating to the same matters.

There has been much written on the matter of scienter in actions under Rule 10b-5, and especially in the departure from the initial pure fraud concepts. The movement toward modified scienter requirements and the use of negligence language has been fully described. It would serve no useful purpose to analyze it further here. The change has taken place in many jurisdictions. See the decisions of this court hereinafter considered; also, Parrent v. Midwest Rug Mills, Inc., 455 F.2d 123 (7th Cir.); City National Bank of Fort Smith, Ark. v Vanderboom, 422 F.2d 221 (8th Cir.); Ellis v. Carter, 291 F.2d 270 (9th Cir.).

We have considered the arguments that to move the standards entirely into the negligence field may likewise move the statutory basis for Rule 10b-5 out from under section 10b, which has no negligence language.

This court in Gilbert v. Nixon, 429 F.2d 348 (10th Cir.), considered an appeal which raised claims based on Rule 10b-5 and also on section 12(2) [15 U.S.C. § 771(2)]. The court there referred to the statutory standards in section 12(2) and held a similar test to be applied in the combined claim. In Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), a Rule 10b-5 case, we referred to the holding in Gilbert v. Nixon, and there said that the defendant, Texas Gulf Sulphur, did not sustain its burden of proving that it did not know the statement in issue was false," . . . nor was it demonstrated that with due diligence TGS could not have known of the faultiness of the statement." See also Allen v. H. K. Porter Co., 452 F.2d 675 (10th Cir.). The Mitchell case was decided after the case before us now.

In these same decisions, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), and Gilbert v. Nixon, 429 F.2d 348 (10th Cir.), we have expressed the requirement that the plaintiff must also exercise good faith in its purchase, due diligence, and demonstrate reliance on the acts or inaction of the defendant.

The case before us does not present any significant new issues except those which arise from the different nature of the event upon which the cause of action is based. Here the plaintiff complains that the special earnings report of defendant should have been issued some days before it was. We are thus concerned only with the issue of the timing of the special statement on earnings. This is silence at the time of the occurrence of the operative events in the corporation's business until the statement was issued, and more particularly the issue becomes whether the silence of defendant at the date or dates of the stock purchases by plaintiff here give rise to a cause of action under Rule 10b-5. This matter of silence is somewhat different from instances where a financial or other type of statement is released and the issue is whether the statement is correct, because in the latter there is a reasonably direct way to test the statement against the facts as they existed, all of which involve objective matters. However, where the silence is at issue, the proof must be directed to the corporate and individual reactions to the facts showing a change in corporate circumstances, and how the decision was reached to issue a statement at a particular time. In these considerations the evidence, as indicated in this record, is well within the decisional processes of the corporate financial specialists and corporate management. The silence or the timing are matters which require the court or the jury to examine how these decisions were arrived at by using many subjective factors and by excluding hindsight.

Thus was the management correct in here evaluating the significance of the slowdown in the aircraft manufacturing process as to extent and impact on earnings during a particular period so as to require the issuance of a special earnings statement? Secondly, was this process conducted with reasonable dispatch considering the need to ascertain the details as to the particular problems, to relate them to other earnings,and to arrive at a conclusion with confidence that the statement when issued would be correct? These factors take us so much farther within the corporate decisional processes than do misleading statements actually issued.

Since the timing decision is one concerned fundamentally and almost exclusively with matters of discretion and the exercise of business judgment, it is appropriate to consider the rationale of the "business judgment". This has long developed in actions brought against corporate officers and directors by stockholders and former stockholders concerning decisions of such officials calling for the exercise of their discretion as to significant corporate matters, made in good faith. Briggs v. Spaulding, 141 U.S. 132; The Herald Co. v. Seawell, Nos. 691-70 and 692-70,_____ F.2d _____ (Tenth Circuit, December 29, 1972). See Fletcher, Cyclopedia of Corporations, § 1039. The business judgment rule has been expressed in a variety of ways but it may be stated that the directors and officers of a corporation will not be held liable for errors or mistakes in judgment, pertaining to law or fact, when they have acted on a matter calling for the exercise of their judgment or discretion, when they have used such judgment and have so acted in good faith. The reason for the rule is stated to be that in order to make the corporation function effectively, those having management responsibility must have the freedom to make in good faith the many necessary decisions quickly and finally without the impairment of having to be liable for an honest error in judgment. The rule itself, of course, is not directly applicable, and it is not to be so applied here, but the reasons for it are con-

sidered as extended to the corporate entity. The Second Circuit in Securities & Exchange Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), said in a footnote that the *timing* of the disclosure of material facts " . . . is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC." The court there held a valid corporate purpose was served by withholding information from the public on the discovery of ore in a test drilling, thus a matter within the "business judgment" of management. Thus considering the factors compelled to be evaluated in this silence case as revealed in the record before us, we must hold that the decision of the officers or directors, and the corporate decision of the defendant to issue an earnings statement on other than the customary date for such statements, and the timing of such statement was a matter of discretion.

On another point, we held in Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), that the information about which the issues revolve must be "available and ripe for publication" before there commences a duty to disclose. To be ripe under this requirement, the contents must be verified sufficiently to permit the officers and directors to have full confidence in their accuracy. It also means, as used by the Second Circuit, that there is no valid corporate purpose which dictates the information be not disclosed. As to the verification of the data aspect, the hazards which arise from an erroneous statement are apparent, especially when it has not been carefully prepared and tested. It is equally obvious that an undue delay not in good faith, in revealing facts, can be deceptive, misleading, or a device to defraud under Rule 10b-5.

Some further brief references to the record are necessary to demonstrate the application of law to the facts before us. The executive vice-president of the plain-

tiff fund testified as to the news report on the purchase by United Airlines of twenty-four Douglas DC-8 jets for two hundred million dollars. He said that his company had been considering the purchase of either Boeing or Douglas stock since the end of 1965, "... and this particular release indicating that United had purchased another $220 million of Douglas Aircraft jets triggered me to call a meeting of the investment committee of Financial Programs and suggest to the director of research who had been following this company personally that it now seemed like an appropriate time to purchase the stock." He continued to say that he was of the opinion that Douglas could make more money on this particular airplane than on the newer DC-9. He also testified that the purchase began the next day, and he expected that it would take several weeks to purchase 100,000 shares of Douglas. He testified as to the wide fluctuations in the price of Douglas stock. He said also:

> "Prior to June 24 we thought that Douglas Aircraft Company would report a profit for the second fiscal quarter ending May 1966,"

and

> "The report of June 24th for the six months ending May 31st, when compared with the five months ending April 30th, indicated that there was a very major loss in the month of May of 1966."

This officer of plaintiff also testified that he was aware that Douglas "... had some problems as early as April 1966." He described these problems as slow deliveries of engines and landing gear assemblies to Douglas from suppliers which caused delays in production. He was aware and took into account the Douglas report of June 1st of a slowdown in manufacture and delivery of planes with an adverse effect on 1966 earnings. He testified he

also was aware in early 1966 of the labor problem Douglas was having, and the effect of the war on delivery of components. As to the earnings figure compiled by plaintiff he said a wide range was necessary because: "The very nature of Douglas business made their earnings volatile." He expected the United order to be reflected in earnings the following year. He said also that the purchase was with the intention of a long-term holding. The record shows that plaintiff employed some ten persons as stock analysts, but no report was received from them as to this purchase.

The officials of Douglas testified that at the annual meeting on April 20, 1966, the stockholders were told that earnings would be better for the coming year (1966) than for the previous year which was $3.15 per share. Then in the latter part of May the president became concerned with the profits in the Aircraft Division, and a financial review was begun. The president organized a group of officials to look into the matter over the Memorial Day weekend and report on May 31st. This was done and the group reported that costs were up and earnings would drop for the year to about $2.00 per share. The company then on June 1st issued a statement which did not give an estimated dollar figure for earnings as it was a company policy not to do so, but stated that there would be delays in the delivery of DC-8s and DC-9s and this would have an adverse effect on 1966 earnings.

The president of Douglas testified that about June 17th, new estimates of earnings were given him out of a continuing discussion of the matter. A new group was then formed to investigate the aircraft costs and earnings and this group submitted an estimated figure on June 20th of forty-nine cents. He testified that the study and concern continued and on the evening of the 23d of June, the company financial group and the auditors worked on the figures again preparatory to a press release to be made the next day. This last analysis

revised the prior figures and arrived at the twelve-cent figure after an inventory write-down. This was included in the press release of June 24th.

The principal Douglas official in the section concerned with financing testified that on June 14th, for the first time the decline in earnings was serious and became apparent to him. He had that day received figures by telephone from the Aircraft Division as part of its periodic report due the day before. This telephone report was a listing of figures and showed a very large loss for the month of May — much more than had been anticipated. This official with the company comptroller visited the Aircraft Division the next day to find out what had happened to the prior cost estimates. The matters were discussed and the outside auditors were called in to advise whether a writedown of the inventory would be required. This was decided to be done, and it further reduced the earnings. Management was advised and steps were taken as above described, culminating with the issuance of the special earnings statement.

The plaintiff put in considerable testimony directed to the five month earning figure (December through April 1966) contained in the preliminary prospectus prepared in anticipation of the issuance of new debentures authorized by the board of Douglas on June 1st. This showed figures from which earnings for that period of eighty-five or eighty-nine cents per share could be derived. The principal accounting officers of Douglas testified that this was a correct figure for the period covered. The serious loss in May plus the large resultant write-down of inventory produced the figure for the six months ending May 30th which was also correct, and thus there was no inconsistency. The May loss plus the write-down had a significant effect on the six-month figure used in the June 24th release. This witness, having been questioned as to the known existence of delays in the delivery to it by suppliers, and of labor problems, said of translating these general conditions into figures:

"A And that is the point of time when you make this estimate. That's what I am trying to get at, that there is no way to reach those things. You know you have a situation, but the only point you can measure it and put numbers and dollars on it is that particular point of time when you have gone through the detail of building up your cost estimates and arrived at your final estimates.

"Q And your point of time, according to your view of it, is at that time, as of May, and no other time?

"A Exactly."

An important factor in the proof was the matter of the call of the old issue of convertible debentures in which both Douglas and Merrill Lynch participated. At the effective date the debentures could be converted to stock on the basis of $77.00 per share of stock to be issued by the company. The market price was above that figure at the time and virtually all debenture holders so converted.

As indicated above the principal executives of Douglas did the preliminary work on a new larger issue of debentures some time in April and secured formal board approval on May 1st. Merrill Lynch was the underwriter for this issue. In this capacity Merrill Lynch participated in the preparation of the necessary preliminary prospectus and the data for the registration. Both worked with the data for these purposes. Merrill Lynch was thus furnished financial information during the pertinent period up to and including the special earnings statement of June 24th. Merrill Lynch had a real interest in the financial condition of Douglas at this period, and apparently had full information. The record shows that Douglas gave Merrill Lynch the opportunity to withdraw, but it did not do so. Merrill Lynch is not a party to this appeal and thus the issues and the record are considered only as to Douglas.

It is apparent that a decline in earnings at the pertinent time would cause problems in connection with both issues of debentures for Douglas and more so for Merrill Lynch. The record shows there existed as to Douglas a strong motive for it to withhold information as to a decline in earnings. This proof is clear in the record and occupies, with the inferences sought to be drawn, a considerable part of the record.

In the setting of this motive the record shows: the known slowdown in the assembly of planes with delays expected in the finished product; the investigation, and the public announcement of May 1st of the slowdown with the warning that it would " . . . have an adverse effect on earnings" for the current period. The problem in May was indicated and management reacted (again) on the 14th of June when the May figures began to come in, showing a serious financial impact in May. However, there is nothing in the record other than speculation that the extent of the May loss could have been determined and translated into figures at an earlier date to develop a statement ripe for publication. The record thus shows without contradiction as to the defendant McDonnell Douglas as a matter of law that there was exercised good faith and due diligence in the ascertainment, the verification, and the publication of the serious reversal of earnings in May.

Much of the earnings decline was caused by the large write-down of inventory, and the need for this as a proper accounting measure is not challenged by plaintiff. There were questions by plaintiff as to the timing of the write-down but the decision was not seriously challenged.

Furthermore there was no showing by plaintiff of the reliance required nor facts to meet the standard of due diligence on its part. It is apparent that an earnings statement issued by a corporation at any but the expected time which shows any substantial change is bad news for someone who had been recently in or out of a fluctuating market.

To prevail the plaintiff in this silence case had the burden of proof to establish that it exercised due care in making its stock purchase, that the defendant failed to issue the special earnings statement when sufficient information was available for an accurate release (or could have been collected by the exercise of due diligence), and to show there existed a duty owed by the defendant to the plaintiff to so disclose as to do otherwise would be a violation of Rule 10b-5, and upon inaction under such showing plaintiff relied to its detriment. The defendant as a separate defense could show either good faith or the exercise of good business judgment in its acts or inaction. The evaluation of the significance of the change in defendant's earnings as it might affect the corporation, its stockholders, or persons considering the purchase of stock, called for the exercise of discretion, and upon a showing of the exercise of due care in the gathering and consideration of the facts, a presumption arose that the evaluation made was in the exercise of good business judgment although subsequent events might show the decision to have been in error.

Mention should be made of our decision in Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), where there was no direct holding as to the standard of care required of the defendant as to the contents of a statement actually issued because the statement there concerned was obviously and intentionally misleading, as the trial court and this court indicated. So we did not there expressly require that the defendant meet a burden of showing due care although such would have been a defense. The burden of showing lack of due care in such circumstances is part of the plaintiff's case.

Under the standards herein set out, the trial court should have granted the motion of defendant Douglas for judgment notwithstanding the verdict. We have considered the evidence most favorably to the plaintiff, and have given it the benefit of all reasonable inferences which may be drawn from the evidence. Gulf Ins. Co. v.

Kolob Corp., 404 F.2d 115 (10th Cir.); Giblin v. Beeler, 396 F.2d 584 (10th Cir.); Jamaica Time Petroleum, Inc. v. Federal Ins. Co., 366 F.2d 156 (10th Cir.); Peter Kiewit Sons Co. v. Clayton, 336 F.2d 551 (10th Cir.). In so doing we have separated the evidence relating to Merrill Lynch from that relating to Douglas. The evidence as to Douglas, as indicated above, shows the presence of a strong motive to delay the publication of figures showing a decline in earnings, but there is no proof that there was such a delay within the legal standards set forth above. There was speculation and innuendo, but no facts. Thus under the standards heretofore set forth by this court and herein described, the trial court should have granted defendant's motion for judgment n.o.v. We point out that our decision in Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), was after the trial in this case, also that a full expression of the law applicable to these unusual circumstances had not been heretofore made by this court.

The judgment is REVERSED and the case remanded with directions to enter judgment for the defendant, McDonnell Douglas Corporation, notwithstanding the verdict.

APPENDIX F

MARCH TERM — APRIL 5, 1973

Before Honorable David T. Lewis, Chief Judge, Honorable Delmas C. Hill, Honorable Oliver Seth, Honorable William J. Holloway, Jr., and Honorable James E. Barrett, Circuit Judges

FINANCIAL INDUSTRIAL FUND, INC., a Maryland corporation, *Plaintiff-Appellee,*	)
v.	)
McDONNELL DOUGLAS CORPORATION, a Maryland corporation,	) No. 71-1387) No. 71-1388) No. 71-1389
Defendant-Appellant.	)

This matter comes on for consideration of the petition for rehearing filed by the appellee.

Upon consideration whereof, the petition for rehearing is denied.

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In the Supreme Court of the United States

October Term, 1972

No. 73-32

FINANCIAL INDUSTRIAL FUND, INC.,
Petitioner,

v.

McDONNELL DOUGLAS CORPORATION,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit (App. E to petition) is reported at 474 F.2d 514. The opinion of the United States District Court for the District of Colorado denying respondent's motion for summary judgment (App. A to petition) is reported at 315 F.Supp. 42. The opinion of the District Court denying motions for judgment notwithstanding the verdict and for new trial is not officially reported, but is set out in Appendix D to the petition and has been reported at CCH Fed. Sec. Law Rptr. ¶ 93,004.

JURISDICTION

The opinion of the Court of Appeals was entered on February 20, 1973, and the petition for rehearing was denied on April 5, 1973. Petitioner seeks to invoke the jurisdiction of this Court under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

Where the petitioner (plaintiff below) purchased 80,000 shares of respondent's stock in the open market in the face of public information that earnings of respondent would be adversely affected by delays in aircraft manufacture and further public information that respondent had had no earnings for the most recent two months; where petitioner's purchase had been triggered by a press release issued by an airline describing an additional order for respondent's aircraft yet to be manufactured, and where respondent had resorted to and was exercising reasonable and prudent steps to assure that proper and accurate earnings figures reflecting additional items just coming to its attention would be promptly released to the public and financial community, was the decision of the court below correct:

1. When it ruled, under these facts, that the petitioner was not entitled to recovery;

2. When it held that respondent had no duty to the investing public to disclose varying and tentative preliminary estimates of quarterly and semi-annual earnings before the earnings figures and the proper accounting treatment with respect thereto were finally determined;

3. When it found that petitioner, having purchased the stock despite substantial unfavorable information known to petitioner, without the benefit of substantial investment analysis of which it was capable, and more than two weeks before the release of respondent's quarterly and semi-annual earnings was anticipated, was foreclosed from recovery based on the alleged failure of respondent to more hastily issue additional unfavorable earnings information.

4. In holding that respondent's prompt and diligent activity to ascertain the hard facts before releasing quarterly and semi-annual earnings figures to the public was a matter

within its discretion and responsibility for which no liability would result under S.E.C. Rule 10b-5 so long as that discretion was not abused?

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES INVOLVED

In addition to the authorities cited by petitioner, also applicable herein is Rule 50, Federal Rules of Civil Procedure.

ADDITIONAL STATEMENT OF THE CASE

Respondent is the successor by merger in 1967 of Douglas Aircraft Company ("Douglas") and the McDonnell Company. We believe the opinion of the Court of Appeals en banc fairly states the important and operative facts. (Petition, App. E, pp. 40a-43a, 47a-51a).

Petitioner's statement of the case is selective and argumentative. In the interest of brevity, we do not set out here all of the facts we deem important and which petitioner has ignored or characterized in argumentative fashion. We do, however, point out certain facts and matters we believe merit highlighting here.

First, and of importance to whether this Court should grant the writ, is that the facts involve what occurred within a limited time applicable only to Douglas and involving only its operations, expectations, investigations and revelations.

This action arose from the purchase by petitioner Financial Industrial Fund, a registered open-end investment company, of 80,000 shares of common stock of Douglas in the open market on June 22 and 23, 1966. (R. Vol. IX, p. 7). On June 24, 1966, before the opening of the stock for trading, there was disseminated a concededly accurate press release stating that Douglas' earnings for the six months ending May 31, 1966, were 12 cents per share. (R. Exh. D-3, Vol. XI, pp. 942-43; Vol. I, p. 110). The price of Douglas stock subsequently declined, and petitioner liquidated its holding of this stock. (R. Vol. I, p. 114).

Petitioner's basic contention below centered around the fact that Douglas had not disseminated the 12 cents per share earnings figure before June 24th, while respondent contended Douglas had exercised due diligence and good faith in ascertaining, verifying and disseminating the earnings figure before release to the news media and the public. Prior to that time, the tentative and fluctuating earnings estimates were not ripe for publication.

It was undisputed below that prior to its purchase, petitioner neither had any contact with nor attempted to contact Douglas concerning either its actual or anticipated earnings (R. Vol. II, p. 158), and that petitioner's purchase was "triggered" (R. Vol. II, p. 186) by a true announcement by United Air Lines on June 21st that it was purchasing $220 million worth of Douglas DC-8 and DC-9 aircraft. (R. Vol. XI, p. 1003; Vol. I, p. 91; Vol. II, p. 191).

There was no proof of any insider trading by Douglas, nor was there any proof that Douglas stood to gain or did gain from any delay in releasing the earnings figure, or that Douglas "leaked" any information regarding earnings. (R. Vol. VII, p. 994).

REASONS WHY THE WRIT SHOULD BE DENIED

The decision of the Court of Appeals was correct and was in accord with applicable decisions of this Court and the courts of appeal. The true basis for petitioner's claim here is not that the decision of the Court of Appeals below is in direct conflict with any decision of this Court, or with that of any other court of appeals, but rather that in the particular factual circumstances involved in this case, petitioner believes the decision was incorrect. Of course, this Court does not sit simply as a court of errors and the dispute here does not raise the kind of question which makes this action worthy of the grant of certiorari.

1. The decision below does not conflict with the decision of this Court or of any court of appeal.

The ruling below by the United States Court of Appeals for the Tenth Circuit does not conflict with either the

decisions of this Court or the decisions of any court of appeal. For example, the very formulation of the rule of which plaintiff complains, that a duty to disclose arises only when the information which ought to be disclosed is "available and ripe for publication," had previously been adopted both in the Tenth Circuit in *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971), *cert. denied*, 404 U.S. 1004 (1971), and by the Second Circuit in *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969).

Petitioner is not able to point to a single case which calls for the adoption of or the adherence to a different standard. Instead, petitioner argues simply that the adoption of that standard, by these courts, undermines the statutory purpose of full disclosure in the securities industry. But the philosophy of full disclosure underlying the securities laws does not require the dissemination of tentative, unripe or possibly misleading information. That philosophy also does not convert companies whose securities are listed on national exchanges into insurers of investment decisions of the public.

Petitioner's suggestion also ignores two important policy considerations recognized by the Court of Appeals below. First, companies are managed by their boards of directors and their officers, and for sound economic and social reasons, the courts generally defer to the policy judgments of such managers unless the range of decision is clearly abused. The "business judgment" rule, recognized by statute or decision in all states, has long stood the test of time. Fletcher, *Cyclopedia of Corporations* (Perm. Ed.) § 1039. Courts do not sit to re-examine de novo such judgments made in good faith. They have shown, and must show, more restraint. A second important rule is that "hindsight" is not the gauge of possible liability, but that the actions complained of must be viewed through the lens of what defendant knew the situation to be at the time. *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, *supra* at 518.

When the full disclosure policy underlying the securities

laws comes into play in a case in which the business judgment and non-hindsight policies are also present, there is required a judicial accommodation between the wholesome policies underlying all three approaches.

Such an accommodation was achieved below, and in the Second Circuit. It should not be upset, or further reviewed, here, especially when petitioner has failed to come forth with a satisfactory alternative standard or proposed rule.

The standards set forth below are well-reasoned and need not be re-examined here:

> ". . . Rule 10b-5 is violated whenever assertions were made, as here, in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media, [citation omitted], if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated." *Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra* at 862.
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> • • •
>
> ". . . the information about which the issues revolve must be 'available and ripe for publication' before there commences a duty to disclose. To be ripe under this requirement, the contents must be verified sufficiently to permit the officers and directors to have full confidence in their accuracy. It also means, as used by the Second Circuit, that there is no valid corporate purpose which dictates the information be not disclosed. As to the verification of the data aspect, the hazards which arise from an erroneous statement are apparent, especially when it has not been carefully prepared and tested. It is equally obvious that an undue delay not in good faith, and revealing facts, can be deceptive, misleading, or a device to fraud

under Rule 10b-5. *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., supra* at 519.

Petitioner has not advanced any legal standard other than that called for by the courts of appeal but simply suggests that had petitioner purchased the stock involved from respondent, respondent would have had a duty to postpone the transaction or disclose. Petitioner's suggestion ignores the fact that plaintiff did not contact or even attempt to contact respondent before its purchase, and that there was no inside trading here. Moreover respondent acted equivalently to postponing a face to face transaction—it acted to arrive at and verify the information before disseminating it to the public. The effect of taking petitioner's suggestion would require respondent to be held liable for taking the time (four days) to ascertain the proper accounting treatment and extent of the adjustments required by the recently-concluded quarterly review, and to issue its earnings statement. Surely the expenditure of such a limited amount of time for such a bona fide purpose cannot give rise to liability.

Had respondent disclosed on June 20th even the tentative information it knew then, there could have been actions brought by persons who purchased on June 17th. Had the respondent disclosed on the 17th, there could have been actions brought by persons who purchased on the 16th, and so on. Thus, whenever a determination is made by a company to disseminate information, there is always a party who may have purchased or sold in the market who can claim he would not have done so had the information been disclosed one or two days earlier. In addition, the Court of Appeals was clearly correct in noting that "the hazards which arise from an erroneous statement are apparent, especially when it has not been carefully prepared and tested." *Ibid.* We submit that the Court of Appeals was clearly correct in holding that where, as here, there is no evidence of bad faith or undue delay, a corporation cannot be held liable under Rule 10b-5 for securities fraud in connection with the dissemination of accurate information concerning its earnings, because it did not more hastily issue tentative information.

Moreover, petitioner has now, for the third time, changed its basic theory of the case—apparently in the hope that if two theories have not succeeded, a third theory may. Thus, in the Pre-Trial Order, the factual issues were formed in terms of alleged "tipping" by Douglas to Merrill Lynch and others in the June 17 – June 23 period. This emphasis was reiterated before trial, when in petitioner's memorandum opposing summary judgment, its counsel stated:

> "In this case it is unnecessary to consider whether defendants were required to release materially revised earnings information to the public prior to June 24, 1966. The important fact is that both or one of them chose to make non-public releases prior to June 24, 1966, and that if plaintiff had known of this, it would not have purchased Douglas stock." (R. Supp. Vol. IX, p. 14).

When the trial court ruled that "tipping" was not a viable theory, and that at trial that there was absolutely no evidence of tipping by Douglas (R. Vol. VII, p. 994), petitioner reversed its field and argued that the 12¢ earnings figure was the heart of the case. In rebuttal in closing argument, petitioner's counsel argued:

> "But, in any event, we ought to get around to what really is this case; what is the meat in the coconut here. It comes down strictly to a failure to disclose promptly to the public a basic material fact. And that is the actual earnings of the first six months of the 1966 fiscal year." (R. Vol. VIII, pp. 3-4).

Having been rebuffed by the Court of Appeals on this theory, after having been rebuffed by the trial court on its tipping theory, petitioner now stresses a long term manipulation theory. We respectfully submit that the alleged failure to disclose promptly was given full and adequate review below by the Court of Appeals en banc, and that there is no necessity for this Court to review the action again, either on that theory, or on a claimed manipulation theory or any other approach.

2. Even if the Court of Appeals had applied the incorrect legal standard to measure the timeliness of disclosure, this Court would still be required to affirm, and would not reach that issue, because of petitioner's demonstrated lack of due diligence before the purchase herein, or because causation of harm could not be demonstrated.

In this case, petitioner, a professional investor, showed a glaring lack of due diligence—even to the extent of ignoring financial estimates in its own files.

An officer of petitioner was asked point-blank what he relied upon to purchase, and he answered:

> "I relied basically on two facts: first, *continuing estimates of increases in the earnings of Douglas for 1966, and subsequent periods due to the large number of orders they were receiving*; and secondly, an increasing confidence that these earnings would be reflected in high price earnings multiples so that ultimately the price would be higher than the price we paid for it." (Emphasis supplied) (R. Vol. II, p. 137).

Yet, the increasing estimates for 1966 he purportedly relied on were proved not to exist. Brokers' reports in petitioner's own files established a *downward* trend:

Co. Making Analysis	Date of Report	Analysts' Estimate of Douglas 1966 Earnings
Baker Weeks	Jan. 4, 1966	$4.75
Hutton	Jan. 1966	4.50
Pressprich	Jan. 1966	4.25
Dean Witter	Jan. 12, 1966	4.00
Smithers	Jan. 18, 1966	4.50
J. Barth	Feb. 21, 1966	5.00
J. Barth	Feb. 1966	4.75
Dean Witter	Feb. 24, 1966	4.25
Goldman, Sachs	Mar. 14, 1966	4.00-4.50
Baker Weeks	Apr. 4, 1966	4.75
Sutro	Apr. 21, 1966	No estimate
Baker Weeks	Apr. 28, 1966	4.50
Donaldson, Lufkin	May, 1966	4.50-5.00
Bank of New York	May, 1966	4.15
Baker Weeks	May 19, 1966	4.00-4.25
Coleman	June 6, 1966	3.30-3.50
Baker Weeks	June 6, 1966	3.25-3.50
Baker Weeks	June 16, 1966 (R.Exhs. G-T, Vol. I, p. 71).	3.00

Merrill Lynch had reduced its earnings estimate but was not contacted. (R. Vol. IV, pp. 396-7). Respondent issued a bearish press release only three weeks before the purchase. (R. Exh. AM-37, Vol. XI, p. 884). Petitioner ignored the published lack of earnings for March and April, 1966 shown by the preliminary prospectus of June 7. (R. Exh.

R, Vol. XI, p. 997 (4); Vol. II, p. 170). Petitioner did not contact respondent before the purchase. (R. Vol. II, p. 158). Although petitioner intended to purchase a very large and substantial position in the stock, it failed to use an aerospace analyst it had recently hired to investigate and report on Douglas. (R. Vol. II, p. 160). Petitioner was aware that in 1966, before the purchase, the price of Douglas stock had ranged from 60 to 112 dollars per share. (R. Vol. I, p. 104).

Notwithstanding all these factors, despite the bearish report concerning Douglas which petitioner received on June 2, and despite the fact that it knew the effect of the United Airlines order announced on June 21 by United was simply to add to Douglas' huge backlog of $2.8 billion but would not add to earnings in fiscal year 1966 (R. Vol. II, p.179), petitioner proceeded on June 22 and 23 to purchase a $7 million position in Douglas stock. If there were ever a case of an investor failing to proceed with due diligence, this is that case. In *Mitchell*, *supra*, at 103, the Court of Appeals properly ruled that plaintiff Stout was barred from recovery by reason of ignoring information which was publicly available. A fortiori, when a professional investor ignores public information and data in its own files or fails to carefully carry through its own investigation, it should be barred from recovery.

Any reasonable man reviewing the lack of diligence exercised by petitioner had to conclude that the injury to it was caused by its own lack of care, rather than by acts or omissions of respondent.[1] The Court of Appeals properly so held.

Nor could the petitioner prove below that any breach of duty by respondent of which it complained caused it harm.

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[1] Petitioner apparently argues (petition 17) that the fact of its "sophistication" in the investment field does not relieve respondent of its alleged duty to disclose tentative estimates. Whether this be correct or not, the fact remains that *no one* should be permitted recovery when it chooses to ignore what it knew or should have known from facts within its files, records, or research data repository. *Clement A. Evans & Co., Inc. v. McAlpine*, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied sub nom. Clement A. Evans & Co., Inc. v. A. M. Kidder & Co.* 402 U.S. 988 (1971).

As the Court of Appeals noted, petitioner purchased by 9:15 a.m. (Denver time) (R. Vol. II, pp. 213-4) on June 22, 1966 the 57,000 shares as to which the jury rendered the verdict in its favor. Yet the meeting by Douglas with its accountants at which the inventory write-down was finally agreed upon was not concluded until after petitioner had completed these purchases. (R. Vol. IV, pp. 510-12). That meeting resulted in the 12¢ figure becoming firm, and that figure was publicly disseminated less than 48 hours later, before the opening of trading on June 24. Had respondent instantly made the information public, it would not and could not have prevented petitioner's purchase.

Moreover, petitioner's purchase on June 22 was triggered by the June 21 United Airlines story, which announced, in part, purchases by it of Douglas-manufactured aircraft. There was admittedly nothing untruthful in that story.

Thus, no action or inaction of Douglas could have been the cause in fact of any harm to petitioner, and the Court of Appeals ruled properly.[2]

3. The Court of Appeals correctly applied the proper legal standards in setting aside the jury verdict.

The Court of Appeals' ruling with respect to setting aside the jury's verdict is brief, and is quoted here:

> "Under the standards herein set out, the trial court should have granted the motion of defendant Douglas for judgment notwithstanding the verdict. *We have considered the evidence most favorably to the plaintiff, and have given it the benefit of all reasonable inferences which may be drawn from the evidence.* [Citations omitted]. In so doing we have separated the evidence relating to Merrill Lynch from that relating to Douglas. The evidence as to Douglas, as indicated above, shows the presence of a strong motive to delay the

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[2] Although the Court did not put its ruling in those terms, its holding of lack of reliance, 474 F.2d at 521, was a holding that the causation required for liability was not here present for the reasons stated above.

> publication of figures showing a decline in earnings, but *there is no proof that there was such a delay within the legal standard set forth above. There was speculation and innuendo, but no facts.* Thus under the standards heretofore set forth by this Court and herein described, the trial court should have granted defendant's motion for judgment n.o.v." (Emphasis supplied) 474 F.2d at 522.

In its opinion, the Court cited four prior opinions of the Tenth Circuit Court of Appeals. Each of those decisions sets forth legal standards consistent with the standards set forth by this Court.

The facts in this case were largely uncontroverted, and there was no showing that Douglas unreasonably delayed the dissemination of its earnings figures intentionally or otherwise.

It was also uncontroverted that petitioner purchased the stock on June 22, not on the basis of analysis by one of its research analysts, but rather because of an admittedly accurate newspaper story on June 21 which indicated that Douglas was the recipient of a sizeable order for aircraft which would not result in earnings for at least a year to 18 months.

Petitioner has failed to show why the Court's statement, cited by the petitioner at page 19, is incorrect. That statement is as follows:

> "... it is apparent that an earnings statement issued by a corporation at any but the expected time which shows any substantial change is bad news for someone who had been recently in or out of a fluctuating market."

But the Court did not limit its observations on the lack of petitioner's due diligence to that point. For example, the Court noted that petitioner was aware of a whole host of problems which plagued Douglas and that "plaintiff employed some 10 persons as stock analysts, but no report was received from them as to this purchase." 474 F.2d at 519.

As to the finding of motive to delay, such a finding of motive does not substitute for a finding that there occurred an actual delay. The Court of Appeals decision repeatedly stresses how promptly Douglas officials actually moved to ascertain the earnings information and disseminate it to the public. 474 F.2d at 516-517 and 520.

The Court of Appeals thus properly applied the correct standard in determining that there was no evidence sufficient to permit a reasonable man to conclude that each of the elements requisite to Rule 10b-5 liability had been established by the petitioner below and, therefore, requiring the jury verdict to be set aside.

CONCLUSION

Respondent respectfully submits that the petition for a writ of certiorari should be denied.

Respectfully submitted,
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In the

Supreme Court of the United States

October Term, 1972

No. 73-32

FINANCIAL INDUSTRIAL FUND, INC.,
Petitioner,

v.

McDONNELL DOUGLAS CORPORATION,
Respondent.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY IN SUPPORT OF CERTIORARI

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REPLY IN SUPPORT OF CERTIORARI

The assertions of respondent in the hope of escaping review serve to emphasize rather than dilute the compelling importance of the issues presented. These issues have serious implications far beyond the confines of this single case, as will be apparent upon considering:

I. *Where an issuer corporation has published optimistic earnings reports and predictions and knows that others have published such reports, it has a duty to public investors to disclose adverse facts and developments as soon as they become material.*

As its first and primary reason why review by this Court should be denied, Respondent avers that this case is of too little

importance to merit the attention of this Court—that it is an inconsequential dispute between petitioner and respondent circumscribed by facts which occurred in a limited time period. On the contrary, what is at stake in this case is the fairness, honesty, and integrity of national security markets.

The decisions of this Court cited in the Petition as well as many lower court decisions[1] clearly enunciate the duty of an issuer corporation to make full and complete disclosure of material facts affecting the value of its stock traded on national markets and otherwise. The cardinal legal question of national importance here presented is the extent to which this duty to public investors lies within the discretion and judgment of issuer corporations.

Respondent argues that with respect to the duty of full and complete disclosure to the public, the courts must exercise restraint and defer to "business judgment" and non-hindsight policies; and that all three considerations were accommodated by the Second Circuit in *Securities and Exchange Commission v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968), cert. denied, *sub. nom. Coates v. SEC,* 394 U.S. 976 (1969), and by the Tenth Circuit in this case and in *Mitchell v. Texas Gulf Sulphur Co.,* 446 F.2d 90 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1971). Respondent's argument is fallacious in that the standards applied in the *TGS* cases were not applied below. In the *TGS* cases, the market price of the stock was depressed and public investors sold at a loss

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[1]See, e.g., *Kohler v. Kohler Co.,* 319 F.2d 634, 637-38 (7th Cir. 1963); *Brennan v. Midwestern United Life Ins. Co.,* 417 F.2d 147 (7th Cir. 1969); *Green v. Jonhop,* 358 F.Supp. 413 (D. Ore. 1973); *Kahan v. Rosenstiel* 424 F.2d 161, 173 (3d Cir. 1970), where the Court stated: "***The Act was designed to eliminate deceptive and unfair practices in security trading and to protect the public from inaccurate, incomplete, and misleading information. The thrust of the Act and the decisions interpreting it is to give the investing public the opportunity to make knowing and intelligent decisions regarding the purchase or sale of securities." (424 F.2d at 173)

as the result of a gloomy and pessimistic press release on April 12 to the effect that rumors which had been widely reported in the press regarding the company's mineral discovery in the area of Timmons, Ontario, were exaggerated and without factual basis. On April 16, TGS issued a release proclaiming a major discovery supported by assays of drilling cores and other detailed factual data. It was the equivocal and ambiguous release of April 12 which the SEC and the plaintiffs in *Mitchell* contended to be materially false and misleading. In denying this charge, TGS argued, among other things, that as of April 12 its factual data were incomplete and insufficiently verified, that the release fairly reflected the facts as it knew them on that date, that the release was published in good faith to warn the investing public of the overly optimistic rumors which had been circulated and that the plaintiffs failed to demonstrate that TGS had derived any benefit therefrom.

It was in this factual context that Judge Waterman, writing the majority opinion for the Second Circuit, articulated the standard quoted in Respondent's Brief in Opposition, restated below to include the prefatory rationale here pertinent.

> "***The requirement that a statement may not be found misleading unless its issuance is actuated by a 'wrongful purpose' might well have the effect of permitting the issuers of misleading statements to seek an advantage but to escape liability if the advantage fails to materialize to the degree contemplated, or cannot be demonstrated.
>
> "More important, however, is the realization which we must again underscore at the risk of repetition, that the investing public is hurt by exposure to false or deceptive statements irrespective of the purpose underlying their issuance. *It does not appear to be unfair to impose upon corporate management a duty to*

ascertain the truth of any statements the corporation releases to its shareholders or to the investing public at large. Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media, *Fleischer, supra,* 51 Va. L.Rev. at 1294-95, if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated." *Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra,* at 861-862. (Emphasis supplied.)

The standard of full disclosure and the affirmative defense of due diligence were with reference to the incomplete and misleading press release of April 12, and it was with reference to the same release that the Tenth Circuit in *Mitchell* fashioned its "ripe for publication" language. In that factual context, the Tenth Circuit stated:

"The duty evolving upon a company facing these circumstances is to speak truthfully, accruately, and with total candor as to the material facts. That is not too much to ask of any company with the interest of its shareholders central to its commentary. It is what the SEC demands, what the law requires, and what every stockholder is entitled to. *Sunray DX Oil Company v. Helmerich & Payne, Inc.,* 398 F.2d 447 (10th Cir. 1968), does not forbid this reasoning. In the context of the facts there present, the court felt that a detailed statement would not add to the informed status of investors, but would mislead them due to the nuances

of technical terms used in divulging further information. The problems extant in that off-shore drilling case are not present in the instant controversy.

"It is said that if the courts require factual data in statements such as that originally framed by TGS, issuance of statements will fall out of favor and use. The conjecture is that by requiring a complete statement of material facts, corporations will cease to issue them and the Act will be frustrated in its attempt to keep stockholders informed of material facts. We view this speculation untenable, *for the duty to disclose facts when they become material has not been altered by this decision.* Simply stated, when the material information is available and ripe for publication, the difficulties inherent in formulating a release overbear the accuracy of the statements contained therein. Nor is it reasonable to conclude that the detail of a full release will preclude its publication in these circumstances. Indeed, the thoroughness of the April 16 release stands as evidence to the contrary." *Mitchell v. Texas Gulf Sulphur Co., supra,* at 100. (Emphasis supplied.)

In both these TGS cases, the respective Courts of Appeal held that the April 12 release was deceptive and misleading because it failed to state the material facts known to TGS at that time, notwithstanding TGS' argument that the core drilling and assays thereof had not been completed and verified.

In the instant case, the trial court applied this same standard which was applied by both the Second Circuit and the Tenth Circuit in the TGS cases and rejected the contention of Douglas which was similar to that of TGS. In his opinion denying motions for judgment notwithstanding the verdict, Judge Doyle stated:

"The defendants take the position that since their officers did not come face to face with actual verified numbers, that they cannot be held responsible for withholding information. *However, this is not and should not be the test of actual knowledge.* The question is whether the circumstances were sufficient so that the trier of the facts could justifiably determine that they, and hence the respective companies, were aware of the true conditions. ****Both Douglas and Merrill Lynch were aware from the evidence which was presented that the problems of Douglas were severe and that the earnings picture was fast deteriorating and that when this became public, the Douglas shares would decline substantially.**** *The initial optimistic reports and the withholding of the bad news violated the duty owed by both defendants.*****" Petition pp. 32a-33a. (Emphasis supplied.)

Validation of these statements of the trial judge does not require a review of all of the favorable reports and predictions which persisted through May 3, 1966, when 98% of Douglas' outstanding debentures had been converted into common stock. Respondent points to the fact that it thereafter published "bearish" information which adequately informed the investing public of a deteriorating earnings situation. What was this "bearish" information? First, a registration statement and preliminary prospectus dated June 7, 1966, disclosing that earnings for the five months ended April 30 were substantially the same as earnings for the three months ended February 28; and second, a release published in the Wall Street Journal on June 2, 1966, stating that it expected a few weeks' delay in making deliveries of some eighteen commercial jet airliners and that such delays would adversely affect its earnings in the current fiscal year ending November 30 by pushing some deliveries scheduled for fiscal 1966 into fiscal 1967 instead. (Brief in Opposition, p. 10). There was ample evidence from which the jury could conclude, and did conclude, that this was not a candid and complete disclosure of the material facts

known to Douglas at that time. There was evidence that Douglas was aware of an undercosting problem with the DC9 program early in April, and that a $1 million write-off which should have been reflected in the regular quarterly earnings statement for the fiscal quarter ended February 28, was not reflected in that quarterly statement, nor was it reflected in the special earnings report for the five months ended April 30, which appeared in the June 7 preliminary prospectus (R. Vol. IV, pp. 471-474). In the light of these facts it is accounting legerdemain to hold that the earnings through April were accurate and that the entire loss resulting from the ultimate verification and acknowledgment on June 24 of a $3.7 million write-off was incurred in the month of May.

The president of Douglas testified that as a result of "numbers" brought to him on May 27 he directed a task force of "50 or 75 people" to carefully review the facts in the aircraft division (R.Vol. II, p.p. 272-274) and that between June 14 and June 23 he remembered specifically three earnings figures for the six-months ended May 31. These figures were 14 cents, 49 cents, and 12 cents per share (R.Vol. VI, p. 906), all of which were materially less than the 85 cents per share for the five-months ended April 30 published in the June 7 preliminary prospectus.

Contrary to respondent's assertion, the accommodation of "non-hindsight" and "business judgment" policies was not similarly achieved by the Second Circuit's decision in *Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra,* and by the Tenth Circuit in this case.

The "business judgment" rule is inapplicable to this case. Petitioner at no time asserted any claim against the individual officers or directors of respondent. The Tenth Circuit acknowl-

edged that the rule was not directly applicable but stated that "the reasons for it are considered as extended to the corporate entity.[2]

The reasons were discussed by the Second Circuit in the TGS case, but the rule was inapplicable because TGS had accomplished its business purpose—the acquisition of property surrounding the drill site—prior to the issuance of its misleading release of April 12. In this case, respondent did not show any business purpose for withholding material information or for the publishing of materially deficient reports and half-truths.

"Hindsight" was not mentioned by the Second Circuit in the TGS case. In this case, the Tenth Circuit stated:

> "The silence or the timing are matters which require the court *or the jury* to examine how these decisions were arrived at by using many subjective factors and by excluding hindsight." Petition p. 45a. (Emphasis supplied.)

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[2]In amplification of this statement, the opinion continues: "The Second Circuit in Securities & Exchange Comm'n. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), said in a footnote that the *timing* of the disclosure of material facts '. . . is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC.' The court there held *a valid corporate purpose was served by withholding information from the public on the discovery of ore in a test drilling,* thus a matter within the 'business judgment' of management. Thus considering the factors compelled to be evaluated in this silence case as revealed in the record before us, we must hold that the decision of the officers or directors, and the corporation decision of the defendant to issue an earnings statement on other than the customary date for such statements, and the timing of such statement was a matter of discretion." Petition, p. 47a. (Emphasis supplied.)

The jury had before it many facts relevant to management's decisions and course of conduct, on the basis of which it could evaluate the subjective factors without hindsight. It did not require 20-20 foresight to foresee that the material facts known to respondent and undisclosed to the public at and for many weeks prior to the time of petitioner's purchases would have, when disclosed, a severe impact on the price of Douglas stock.

Petitioner contends, with respect to an issuer corporation's duty to disclose material facts to public investors, that the standard applied by the trial judge to the facts of this case was correct and in conformity with the standards applied by the Second Circuit and Tenth Circuit in the TGS cases above cited and by this Court in the cases cited in the petition. That standard imposes a duty on a corporate issuer of securities traded in national security markets to disclose candidly and completely all of the facts as soon as they become material. Such standard should apply *a fortiori,* where the issuer previously has caused or knowingly permitted to be circulated materially different facts and forecasts.

The standard applied by the Tenth Circuit in the factual context of this case disregards the preceding acts and practices which have influenced the markets and emasculates the materiality test by the inclusion of a purely unilateral element—i.e., that there is no duty to disclose material facts until such material facts can be presented in form and detail satisfactory to the issuer's management.

Petitioner submits that such a standard subverts the philosophy of full disclosure and the maintenance of fair and honest markets.

Respondent's assertion that the petitioner has been rebuffed on certain theories is distorted and unwarranted, being

without adequate explanation as to the parties involved and the development of the issues at different stages in the protracted proceedings below. In any event, the argument that petitioner should not be allowed to change "theories" is untenable. There is nothing in 10b-5 jurisprudence which restricts a litigant to a non-disclosure theory or any other specific theory. Under the public policy declarations of this Court, petitioner may invoke the full panoply of Rule 10b-5.

II. *Public Investors Trading in National Security Markets Are Entitled to Rely on the Integrity of Those Markets and Reliance Upon Prevailing Market Prices Does Not Amount to a Lack of Due Diligence.*

Petitioner contends that its reliance and due diligence were established in accordance with standards established by this Court, as set forth in its petition at pages 16-18. In assailing this contention, respondent has lost sight of the dominant consideration involved in this case—the maintenance of fair and honest markets in securities transactions. In its brief in opposition (pp. 10-11), respondent calls attention to "bearish" information in petitioner's own files including a tabulation of broker's reports establishing a downward trend of earnings and argues "when a professional investor ignores public information and data in its own files or fails to carry through its own investigation, it should be barred from recovery."

Respondent ignores the fact that the same information was known to hundreds of investors trading on national security markets, and the market price of Douglas stock reflected their collective evaluation of such information. Respondent's argument necessarily implies that a "professional" investor who relies on the assumption that he is trading in a fair and fully informed market is not a "reasonable" investor. Profes-

sional investors, like all others, are entitled to candid disclosure of material facts.[3]

Respondent's faulting of petitioner for failing to contact Douglas or Merrill Lynch before making its purchase is unrealistic and baseless. Petitioner was informed by the June 7 preliminary prospectus that earnings for the five months ended April 30 were 85 cents per share. Surely, it was not incumbent on petitioner or any other public investor to contact Douglas or Merrill Lynch to ascertain whether anything was happening which would reduce these earnings to 12 cents per share for the first six months. Moreover, it would have been unlawful for Douglas or Merrill Lynch to have given petitioner any information which it did not give to the entire investing public.

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[3]In *Stier v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973), the court stated: "***The sins of the Defendant against Rule 10b-5 which are before the Court on appeal are ones of omission rather than commission. The trial Judge specifically found that there were 14 facts which the Defendant failed to disclose to the Plaintiff. However, in view of the sophistication and financial acumen of the Plaintiff, his knowledge of the fact that a registration statement had been filed and a prospectus was available upon his request, and his failure to look further into the matter all led the trial court to conclude that Defendant was not in violation of 10b-5.

"We choose not to take issue with the finding that Appellant was a sophisticated investor. We hold that Appellant was entitled to judgment as a matter of law because sophisticated investors, like all others, are entitled to the truth."

CONCLUSION

The issues involved and the legal standards to be applied in the factual context of this case are of national importance and of vital concern to issuer corporations and the investing public. These issues merit the attention and decision of this Court. The writ should be granted.

Respectfully submitted,

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